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# **MODERN INTERNATIONAL ECONOMICS**

# **MODERN INTERNATIONAL ECONOMICS**

**A BALANCE OF PAYMENTS APPROACH**

**EURASIA PUBLISHING HOUSE (Pvt.) Ltd.**

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TO  
ROSE AND IRENE

## PREFACE

There is an aura of unreality about many of the books on international economics. Some describe a world which no longer exists. Others stress theories which do not apply or policies which have ceased to be of importance. Still others overlook the significance of the heavy pressures of changing technology, economically aggressive cold war enemies and new nations clamoring for help and understanding. Facts such as these prompted the writing of this book which includes a new approach to the subject and a treatment of theory, policy, history, institutions and description.

This work has been prepared with the requirements of a number of different readers in mind. It has been designed primarily for use as a textbook in beginning courses on international economics or international trade. Used by itself, it is adapted to a one-semester course in the subject. Studied in conjunction with additional readings as suggested in the bibliographies appended to the chapters it provides the basis of a two-semester course. The book is also intended to be used as a reference work for other courses in economics, political science, history, sociology and geography.

Businessmen engaged in international trade have also been considered in the preparation of this volume. Military officers and government officials whose work entails international responsibilities may find this study of help. Members of clubs and study groups undertaking the examination of current international problems may find much of the material of interest.

The authors owe a debt of gratitude to a number of people. Professors H. W. Guthrie, J. T. Masten, S. T. McCloy, W. Pearce and A. Vandenbosch, all of the University of Kentucky, read some of the chapters and offered valuable criticisms and suggestions. Professors H. W. Hargreaves and L. Zsoldos were particularly helpful in their comments on various portions of the manuscript. Samuel Pizer of the Balance of Payments Division of the United States Department of Commerce read the chapters on the balance of payments in an early draft and helped improve them.

A number of graduate students of the William Andrew Patterson School of Diplomacy and International Commerce and the Department of Economics of the University of Kentucky assisted in the preparation of the manuscript by doing research, reading chapters and offering suggestions. Among these students were Ben Dyer, Desmond Fitzmaurice, Edward Unger, Sue Ware, Ray M. Ware, Lawrence B. Wasserman and Russell Wharton. Irene Hultman performed invaluable editorial work on the several drafts of the manuscript.

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The authors are heavily indebted to the publisher, Russell F. Moore, for help and encouragement. His editorial suggestions at all stages of the work, based on many years of experience in the publishing field, were of invaluable aid.

In addition to the works cited in the footnotes and bibliographies, this volume has drawn heavily on the literature in the field.

While the assistance received is gratefully acknowledged, the authors assume full responsibility for the material presented in this book.

Lexington, Kentucky  
January, 1962

MAX J. WASSERMAN

CHARLES W. HULTMAN

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## The Background of International Economics

"After the way in which the Divine Providence disposed things upon the earth, it is easily seen that He desired to establish union and charity among all men. He imposed upon them a sort of necessity to have constant need for one another. He did not want all things necessary to life to be found in the same place. He dispensed His gifts so that men would trade with one another, so that the mutual necessity of helping each other encouraged friendship among them. It is the continual exchange of all the commodities of life which makes trade, it is this trade which creates the comforts of life, and by its means, there is everywhere an abundance of all things"<sup>1</sup>

Thus Jacques Savary characterized international economics at the end of the seventeenth century in his classic work, *Le Parfait Négociant*, the great-grandfather of all books on commerce. The study of international economics may well be commenced with this quotation from Savary. Generations of European trader's apprentices learned at least a part of their art from his work, which was on the reference shelf of many a master trader of his day and for years thereafter. It was one of the most widely used treatises on international economics of all time.

Savary was writing during the period of the Mercantilist commercial revolution, when the limited horizons of the Middle Ages were giving way to the broader landscapes of a world enlarged by the exploration of new or little-known lands. Although life was restricted in many ways, the tales of returned travellers brought visions of a new, more

<sup>1</sup> Savary, Jacques, *Le Parfait Négociant*, 4th ed 1697, Lyon, France Jacques Lyons, Bookseller, Mercière St., at the Sign of the Good Pastor. Book I, Ch. 1, p. 1.

varied and abundant life. The venturesome traders of the day with their bright, new merchandise from distant places clothed some of these dreams with reality.

Today we know more about the operations of our economy than was known in the time of Savary because there are not only many more facts, but a deeper knowledge of the laws and tendencies which determine the flow of trade and investment. More abundant data exist making it possible to determine the magnitude of these relations and to discern their trends and behavior. The student of international economic relations has much more to learn and understand, than at any time in the past. If the current tendency continues, he will have even more to learn and understand in the future.

Of all man's economic activities, foreign trade is among the most complicated, the most difficult. Its successful prosecution demands knowledge of products and markets all over the world and of the institutions and customs of many nations. It requires that the trader understand men in various climes and environments, with lives, beliefs, and customs quite different from his own. It insists that its practitioners master a complex technology of trading procedures which are in a state of flux. And above all, skill and imagination should form a part of the baggage of all those who travel abroad in the pursuit of business.

### The Modern Commercial Revolution

Today the economic world is undergoing another revolution. True, the great geographical discoveries of the sixteenth and seventeenth centuries are now past but thanks to our rapidly developing communications and transportation, the world is effectively growing smaller and people are getting to know it better. The earlier navigators and explorers extended the world in length and breadth, their modern counterparts are developing it in depth. The roots of modern international economics penetrate all segments of a nation's economy. The international economies of many nations would be profoundly altered if their trading relationships were to decline, increase or change their character.

Another important feature of today's revolution is the awakening of the so-called underdeveloped lands. The dramatic revolution of rising expectations in lands that but recently were colonial dependencies exerts a strong influence upon men the world over.

Whereas under the earlier commercial revolutions there was intense rivalry among nations for world trade, today there is more cooperation among countries both underdeveloped and developed. The list of the organizations of world cooperation is a large one and is still growing. It includes the Organization for Economic Cooperation and Develop-

ment, the European Economic Community, the European Free Trade Association, together with the United Nations and its specialized agencies such as the Economic Commission for Europe, the Economic Commission for Asia and the Far East, the International Bank and Fund among many others.

These cooperative agencies are based upon the premise that there are many economic problems that can best be solved by regional or international effort rather than by national programs. They reflect the view that we can all grow wealthy together and that, after all, each of us is his brother's keeper. Modern international economic cooperation is an important development on the international scene, and it marks a notable departure from the nationalistic rivalries of the past.

Since the turn of the century there have been revolutionary changes, which are still continuing, in the capitalist systems of the western world. These changes have eliminated many of the abuses of private enterprise capitalism which Marx, about a century ago, was able to decry with some reason. Modern capitalism has a greater appreciation of its responsibilities to all of the people, which has brought about higher material standards of living and a reduction of the gap that separates the wealthy from the poor.

Another important characteristic of our economic revolution has been a growing awareness on the part of businessmen and statesmen of the close relationship between purchasing power and production. They have come to realize that unless there is adequate purchasing power in the hands of the consuming public, production and employment will lag. In practice, in the United States, the higher wages and supported prices for farm crops have improved the ability of large bodies of consumers to purchase the products and commodities which the economy creates.

Although it was at first largely a domestic or national policy, this notion has been extended to the external or international economy. Today traders and government officials realize that there is little profitable business to be done with lands having low per-capita national income. In practice, this has meant that the United States has come to the aid of foreign nations with grants of funds, loans and technical assistance to aid them in developing their economies. It is not alone in these programs of economic aid. Other nations have similar programs. Several international institutions are dedicated in part to similar goals.

profoundly altered the international economy and the end of its influence is not yet in sight. Based upon a system of state ownership or control of an economy, communism has virtually eliminated free enterprise in the lands where it has gained ascendancy. Substituting the dictatorship of a relatively small party for the Marxian concept of the dictatorship of the proletariat, or for democracy as practiced by the western nations, political control over the economic activities of the inhabitants of Communist lands has passed into the hands of a small oligarchy supported by armed force.

On the international front, communism seeks to extend its domination over nations by whatever means seem appropriate. Using various devices, the U.S.S.R. and Communist China have acquired large colonial empires. Poland, Czechoslovakia, Yugoslavia, Latvia, Estonia, Albania, East Germany, Vietminh, Tibet and North Korea are the principal colonies of these two empires, each occupied by substantial detachments of the Communist metropolitan military forces.

Thus, the free nations of the West face two formidable empires which pursue different objectives and trading techniques in their international economic relationships. The efforts of the Communists to dominate the yet uncommitted lands color deeply the world's economic relationships and profoundly affect the international economic policies of both Communist and capitalist nations.

Although international trade has always reflected the impact of politics, Communist international trade is more subject to political influence than any of the national systems of private property and free enterprise. The state-owned trade of the Communist nations is partially directed by considerations of political advantage. These nations neither need to break even nor to show a profit in all sectors of their economy at the same time, for they have the resources of the whole nation to support their policies. The individual, privately-owned firms of the capitalist nations cannot afford to trade for political advantage. They cannot sustain continued losses on their transactions if they are to stay in business.

The struggle on the international scene between these two systems of trade is likely to grow more intense. In the long run the conflict will probably be decided by considerations of the relative efficiency of the two systems, by their respective worth to the inhabitants of the world in terms of creature comforts, cultural and spiritual values and in the relative amount of freedom each provides. The modern student of international trade will no doubt have to deal increasingly with the problems arising from this conflict.

## International Inequalities

Peaceful international relations are poisoned by the inequalities in wealth, income and stages of economic development among the nations of the world. Jealousies of some of the "have-not," less developed, countries do not always manifest themselves in implemented programs of self-improvement but may be revealed in the will to decry the better-off nation, in displays of emotional nationalism, in the dislike of other peoples, or xenophobia. International intercourse, cooperation and negotiation are hampered by the barriers which these nations erect and by their desire for self-assertion and recognition.

Steps taken toward the reduction of inequalities lie in the direction of peace and easier international relations. It is quite possible that the USSR and Communist China will become more tractable neighbors as their economies approach the levels already attained by our own for they will no longer need to belittle our accomplishments and will feel more secure in their dealings with us. Other less developed nations will prove better and more convenient trading partners as their economies grow in strength. The international trader, statesman and student can contribute to smoother world relations by working to raise the economic levels of their fellowmen in other lands, wherever they are.

## The Underlying Philosophy of International Economics

An important characteristic of the economic life of our day has been the shift in the objectives of the trade of nations. Only three decades ago it was deemed sufficient that the foreign trader pursue his own self-interest in arranging his international transactions. The "invisible hand," popularized by Adam Smith, guided these transactions so that the foreign trader in pursuing his own goals also worked in the interest of society. He served the nation as well as himself.

Today we are much more demanding. We no longer leave it to chance, to coincidence or to the invisible hand to assure that international trade serves the national interest. International trade must coincide with the domestic objectives of the economy. It must also serve the goals of the nations with which we trade. We look to international economics to build, not only our own welfare, but that of our trading partners as well. International economic relations are now a tool in economic nation-building projects and are no longer exclusively goals or ends in themselves.

and the unknown, the desire to relieve the monotony of long-familiar goods, services and surroundings, the persistent call of man's ego to play the business game on a larger chessboard and with more pieces, man's spirit of generosity, the needs of governments for reliable friends and allies send men to the four corners of the globe in quest of business. And, of course, economic motives are always present—the self-interested search for higher profits, wages, interest, rents, royalties and security which incite men to trade abroad.

Although the underlying philosophy of foreign trade may differ from domestic in certain aspects and the qualities required by the successful foreign trader are not always those of the domestic merchant, it is easy to exaggerate the distinctions between foreign and domestic economic life. There is a strong interaction between the forces which operate in the domestic economy and those which control a nation's external economy. In fact, although economists often separate a country's internal and external economies as a matter of convenience, in actual economic life no such distinction exists. External and internal trade are but two aspects of the same thing—the national economy. Prices, costs, incomes, output, employment, wages, interest, inflation, to name but a few, affect the level and pattern of our domestic economy as well as our ability to trade and invest abroad.

Such is the background of international economics and the setting in which it takes place. This environment is largely man's creation, and as such it can be changed by man. The reader should bear in mind that there is nothing eternal or immutable in the laws or tendencies which govern the way in which our international economic relations function. They have changed importantly in the past and will doubtless continue to change in the future. When these relationships no longer satisfy us, they can, and should, be changed.

### Definition and Classification of International Economics

*Definition of international economics* International economics has for its field of study and practice the traffic in goods, services, gifts, capital and the precious metals as the ownership of these items changes from the residents of one country to those of another. It describes and analyzes this traffic as well as the laws, institutions and practices under which it takes place. It draws inferences, develops tendencies and laws which condition the manner in which international transactions take place.

It is but a part of the larger discipline, economics, and is a field of specialization of this subject. The body of economics has become so complex that no one can hope to master all of it. In consequence, it

is divided into groups of sub-disciplines to facilitate the mastery of parts of it. International economics is one of these parts. Note, however, that many of the principles and theories of international economics are not only consistent with the general body of economic theory, they are but a special application of these more general laws.

International economics is both a science and an art. It is a science because it endeavors to establish a body of facts which shows the nature, characteristics and properties of international relations and the relationships which exist among them. It establishes the laws, principles and tendencies which govern the behavior of men as they engage in foreign transactions. It devises techniques for discovering facts, the relationships among them as well as the elaboration of principles which may be inferred from their analysis.

It is an art in that it utilizes bodies of fact and principle as the basis for private and public actions, programs and policies as well as for the solution of problems which arise in the field.

International economics can be divided logically into certain groups. The following schema presents one classification of the subject, others are, of course, possible. It should be noted that this division is man-made and does not exist in international economic life itself.



*Descriptive international economics.* The bodies of facts which describe the institutions and practices of international economics, their

characteristics and properties are called descriptive international economics. When the institutions and practices described are in the past, they are termed *historical*; when in the present, *current*.

*Analysis of international economics.* The analysis of international economics is concerned with the drawing of inferences from established facts, laws, tendencies, their relationships and trends. When these inferences are drawn by processes of logical deduction from known or believed propositions the result is the *logical analysis* of international trade. When the inferences are drawn by logical processes from newly developed or discovered facts, either quantitative or other, the results constitute the *empirical analysis* of international trade.

*Theory of international economics.* International economic theory is developed as analysis yields inferences which permit the elaboration of laws, principles and tendencies which characterize international economic behavior. If there is a sufficiently conclusive body of fact to establish provable theories, *scientific international economic theory* is developed. If the body of fact is not sufficiently conclusive, *hypothetical international economic theory* is elaborated. The distinction between scientific and hypothetical theory is important because it marks the frontier between positive knowledge on the one hand and belief on the other.

In this respect, international economic theory does not differ from other economic theory or that of the other social disciplines. Much of the data needed to elaborate scientific economic theories are the by-product of private enterprise and are not available to the student. But it should be noted that more economic facts are available to the public under private enterprise than under Communist and other directed economies.

Although both government and business publish much data of use to international economists, all that is needed for scientific work is not as yet available. The factors in international behavior are so numerous that the solution of any problem in the field involves a large number of variables. As yet values and magnitudes cannot be assigned to all of these variables, and techniques for their analysis have not been devised. Under the impact of the work in the field, the body of scientific international economic theory is steadily growing and that of the hypothetical diminishing.

*International economic policy.* Governments, in their operations, their economic relations with other governments and in providing a framework in which private citizens carry out international economic transactions, develop programs and policies which are embodied in laws, regulations, treaties and agreements. This part of international economics

is termed *public international economic, or foreign economic, policy*.

Private businessmen and firms likewise elaborate programs and policies for the conduct of their foreign business relations. These guide business conduct, provide a backdrop against which projected actions and transactions are carried out and evaluated and are the foundation underlying international private business decisions. This part of the subject is called *private international economic, or commercial, policy*.

*Applied international economics* Government officials and private businessmen use the body of international economic knowledge to prepare policies and programs, to solve the problems which arise in day-to-day work, to program activities and to develop projects. Successful work in this field presupposes an extensive and intensive knowledge of international economics, for decisions based upon erroneous or incomplete facts yield disappointment and error. This aspect of international economics is termed *applied international economics*. When used by governments it is *public*; by private citizens, *private*.

International economics has had a long and interesting history and has arrived at its present state of development after many years of trial and error experience. Since knowledge of changes over the years is important in understanding the present world economy, the following chapter continues this introductory survey by providing an historical sketch of its development.

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The following works are general treatises or textbooks covering the whole field of international economics which are recommended as collateral reading to beginning students of the subject

Behrman, Jack N., and Schmidt, Wilson E. *International Economics: Theory, Practice, Policy*. New York: Rinehart and Co., 1957. In addition to its emphasis on policy, this book contains a substantial amount of material dealing with the historical aspects of the subject. It should prove useful to those who wish to place modern theory and problems of policy in their historical perspectives.

Brainard, Harry G. *International Economics and Public Policy*. New York: Henry Holt and Co., 1954. The major emphasis of this work lies in the field of public policy dealing with international economic relations. Since the author apparently regards relations among nations as a fundamental problem of today's world, the theoretical and descriptive aspects of the subject have been held to a minimum.

Enke, Stephen and Salera, Virgil. *International Economics* (3rd ed.) New York: Prentice-Hall, Inc., 1957. This book presents a balanced survey of the entire field without emphasis on one aspect or another of international economics. It is recommended to readers who seek a brief, comprehensive review of the field.

- Harris, Seymour E. *International and Interregional Economics*. New York. McGraw-Hill Book Co., Inc., 1957. This book concentrates upon certain aspects of the field and does not attempt to cover all of it. It contains a lucid exposition of classical international economic theory and emphasizes problems associated with the recent dollar gap and balance of payments disequilibria
- Heck, Harold J. *Foreign Commerce*. New York. McGraw-Hill Book Co., Inc., 1953. The author first outlines the type and character of various international transactions to render the theoretical and policy aspects of the subject easier to understand and less abstract. There is less emphasis on theory than on policy and practice
- Horn, Paul V., and Comez, Henry. *International Trade Principles and Practices*. (4th ed.) Englewood Cliffs, New Jersey. Prentice-Hall, Inc., 1959. Initially published in 1935, this treatise is one of the first in the field which is still in use. It emphasizes the more practical aspects of the subject and was apparently designed for those who feel the need for a minimum amount of theory and policy
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this work is the extent to which the author has joined theoretical and empirical analysis. Considerable attention is also devoted to the problems of international equilibria and balance of payments adjustment.

Tarshis, Lorie *Introduction to International Trade and Finance*. New York: John Wiley and Sons, Inc., 1955. This book develops the necessary economic theories as it proceeds and is well designed for readers with a minimum background in economic theory. Emphasis is on analysis and the solution of problems in the field.

Towle, Lawrence W. *International Trade and Commercial Policy*. New York: Harper and Brothers, 1956. Problems of economic theory and policy are well treated in this work which brings into relief numerous contributions found in monographs and review articles.

Young, John Parke *The International Economy* (3rd ed.) New York: The Ronald Press Co., 1951. Especially strong in descriptive and historical treatment, this work presents a comprehensive and well-balanced view of the entire field. The scholarly chapters on the history of international economic theory and policy are especially valuable.

## Historical Sketch of International Trade

"Behold then the true form and worth of Forraign Trade, which is, *The great Revenue of the King, The honour of the Kingdom, the Noble profession of the Merchant, The School of our Arts, The supply of our wants, The employment of our poor, The improvements of our Lands, The Nurcery of our Mariners, The Wolls of the Kingdoms, The means of our Treasure, The Sinnews of our wors, The terror of our enemies* For all which great and weighty reasons, do so many well governed States highly countenance the profession, and carefully cherish the action, not only with Policy to encrease it, but also with power to protect it from all forraign injuries: because they know it is a Principal in Reason of State to maintain and defend that which doth Support them and their estates."<sup>1</sup>

Thus did Thomas Mun, one of the leading British Mercantilists, explain the role of trade in the welfare of nations. The economic expansion of the modern world began with the growth of trade which brought about an increase in industry and finance. Modern capitalism received its early stimulus from trade rather than from industry. Without the developments in world trade the societies in which we live would be far different from what they are today. Modern economic organization owes much to the innovations, the imagination and the venture spirit of the traders to foreign lands of yesteryear.

International trade is, in part, a matter of definition. In the days

of primitive man, barter among adjoining tribes was doubtless international commerce to the people of those times. In the Middle Ages, traffic between nearby manors and towns was considered to be foreign trade. Today, our concept has broadened and we consider it to consist of transactions between residents of different countries. There is something arbitrary about such a definition because national boundaries are man-made, they have been brought about by the events of history. For example, had the Confederacy been successful in its bid for secession from the United States, trade between the North and South would have been international instead of domestic trade.

### Trade in the Ancient World

Archaeological artifacts and legends afford *prima facie* evidence that primitive man engaged in trade. Excavations of Abraham's city of Ur of the Chaldees indicate that the inhabitants may have traded as far east as the Pamirs of central Asia for lapis lazuli and as far west as Syria for silver. The Arabs, Chinese, Africans, the peoples of the Western Hemisphere, among others, have a history of trade which goes back almost as far as the history of these people themselves.

*Crete and Phœnicia* The people of the island of Crete appear to have been among the first to engage in maritime trade. They carried on commerce in gems, pottery, works of art, ivory and textiles with the Aegean area, Egypt and Sardinia. This trade lasted from about 2500 to 1500 B.C. Cretan leadership in trade drew to a close with the rise in power of a Semitic people, the Phœnicians, who inhabited the eastern shores of the Mediterranean established the cities of Carthage on the North African coast and Tyre and Sidon in Syria, created colonies in Malta, Sicily, and Sardinia and excelled in the art of shipbuilding and navigation.

Natural mountain barriers, which hindered the extension of overland trade, forced the Phœnicians to take to the sea. For about 500 years they carried on trade along the shores of the Mediterranean, the Black Sea, through the Pillars of Hercules, along the coast of Africa and with India. Phœnician exports included glassware, silver, brass and gold articles and dyes, the most important of which was the purple or murex dye yielded by rare shell-fish found along the Phœnician coast. In return, they received fine linen and grain from Egypt, fabrics, bronzes and slaves from Greece and ivory from Cyprus. Carthage, with which the Phœnicians had an active trade, supplied skins, horns, leather, ebony, gorillas and guinea fowl, while the mines of Spain provided silver, tin, iron, and lead. Although coins were in existence, barter was the chief trading method used by this people. Phœnician power and

importance in trade declined as a result of international dissensions, attacks by land powers, and the rise of Greece.

*The Greeks and Romans* Almost imperceptibly the Greeks rose to commercial prominence and gained the place formerly held by their teachers, the Phoenicians. By 500 B C the maritime supremacy of the Greeks was widely recognized. They colonized extensively in Asia Minor, Italy, Sicily, Spain and France. Antioch and Alexandria, each boasting of populations of over 200,000, rose to importance as Greek trading centers. Their imports included gold from Thrace and fish, grain, iron, tin, lead, furs, hair, wax, and slaves from countries bordering the Black Sea. In exchange, they exported figs, honey, olive oil, pottery, fabrics and metals. The Greeks differed from their predecessors, the Phoenicians, in that they developed the natural resources of their colonies and made them centers of civilization and industry. The contributions made by the Greeks in the cultural sphere were in a large measure made possible by wealth derived from trade.

The Romans were less inclined toward trade than the Greeks. Foreign commerce, however, became a necessity to support Rome's rapidly increasing population. Some authorities hold that the *Pax Romana*, which began in 29 B C and lasted for over 200 years, was Rome's greatest contribution to trade. In any event trade flourished during this period. Goods which the Romans traded at that time included Egyptian coin, papyrus and flax and Grecian marble, from France and Spain came silver, gold, iron, copper, wheat, wool, wine, oil, wax, dyes and horses; northern Italy supplied pitch, hogs and millet, furs and iron came from Germany while perfumes and other luxuries flowed in from the Orient. Rome's commercial decline may be explained by many factors, among them a steady depletion of capital, governmental interference in economic life, extensive doles to the poor from public storehouses, the support of expensive public games, and a deterioration in the character of the Roman people.

*Byzantine trade* Rome fell in the last quarter of the fifth century A D, paving the way for Constantinople's ascendancy to commercial importance. The middle of the seventh century witnessed the rapid extension of the Moslem faith. The Saracens believed in conversion by sword and captured Antioch and Alexandria. They dominated Persia, Egypt, Syria, North Africa and even invaded Spain. In addition to these conquests they carried on peaceful trade with India, China, and Sicily.

Among the exports of Constantinople and the Black Sea area were porcelains, oil, fabrics, drugs, gold, carved ivories, spices, fruits, silk and weapons. The principal imports from Europe consisted of linen,

woolen goods and metal articles. There was a marked decline in this trade after the fall of Constantinople to the Turks in 1453.

The people of Constantinople made important contributions to the development of finance, banking and insurance. Promissory notes were used and credit for trade was available at reasonable rates. The monetary system was good and conducive to business while the measure of freedom which traders enjoyed was, for the period, relatively large. In addition, the Saracens held trade fairs and made important contributions to science and learning.

### The Middle Ages

The civilization which the Romans created in Europe after the conquest by Julius Caesar was relatively advanced and included a flourishing agricultural and urban life. The Romans brought with them their customs, laws, culture, architecture, engineering, roads and language. Although there was some trade under the Roman domination, commerce was not an outstanding feature of the Gallo-Roman civilization. Almost from the start of the Roman occupation of Europe, their rule was threatened by the barbarian tribes to the east and the north. In the last half of the fifth century A.D. these barbaric hordes moved south to break through the cordon of imperial Rome, until the city itself was taken in 476 A.D. Roman civilization was crushed and the long centuries of the Dark Ages settled over western Europe.

**500 to 1000 A.D.** Chronologically, the medieval period, or the Middle Ages, is usually regarded as extending from 500 to 1500 A.D. and forms a bridge between ancient and modern times. The Middle Ages can be conveniently divided into two periods, 500 to 1000 A.D. (the Dark Ages), and 1000 to 1500 A.D. During the former, the chief manufacturing centers of the world were to be found in the Orient. Trade during this period was seriously hampered by obstacles to transportation such as large tracts of uncleared land, unfordable, poorly bridged streams, and inadequately maintained highways. The dominant political institutions were feudalism and the manorial system. An outgrowth of the disintegration of empires, feudalism and the manorial system were based upon economic and political self-sufficiency. The powerful lords erected trade barriers in the form of edicts requiring the payment of tolls and customs duties. Migration and travel were often restricted or prohibited.

The Church exercised its powers not only in spiritual matters but in political and economic affairs as well. While the Church preached the doctrine of the just price and just wage, as a result of its hostility to business the progress of commerce was impeded. The concept of profit was anathema, one man's gain was regarded as another's loss.

Interest payments were classified as usury, and the functions of the merchant were regarded as nonproductive. The Church appealed to the ascetic nature of man, endorsing self-denial with obvious effects on commercial development.

Agriculture under the manorial system was the leading, if not the almost exclusive, occupation of the inhabitants of Europe. The flourishing Roman towns and urban life all but disappeared. There was, however, a small volume of trade between the manors and the remaining towns and surrounding countryside.

*1000 to 1500 A D—emergence of a town economy.* At the close of the Dark Ages the old Roman towns began to grow, new towns sprang up at the intersection of routes as ambulant merchants started to ply their trade. Others were established at port locations, while some came into existence around the monasteries. With the growth and development of cities a slow transformation took place in medieval economic organization. In the towns, industry, trade and finance began to flourish, and the agricultural character of economic life was diversified by these additions.

During the period 1000 to 1500 A D commerce was recognized as a legitimate occupation. Industry and trade were organized under the guild system. Each guild had a monopoly over a given trade or craft in the town in which it was located. These associations were formed voluntarily by craftsmen and merchants to protect themselves against competition from the outside. They were an important organic force in the cities because guild and city government amounted at one time to virtually the same thing. Guild members were given the exclusive privilege of trading or manufacturing within a given town, and each guild regulated its affairs much as it pleased. Merchants, instead of being considered of the lowest social rank, were endowed with some dignity after the establishment of the guilds.

In addition to the guilds, some towns possessed market places, and certain regions, fairs. Markets were generally held for one day only; fairs usually continued six to eight weeks, depending on local customs. The markets provided urban agglomerations with necessary farm products. The city dwellers, not far removed from agricultural life, lived in dread of being cut off from the products of the farm and feared starvation. Local markets were, accordingly, regulated to assure a steady flow of essential farm goods, fairly distributed and sold at prevailing competitive prices.

The fairs provided the various regions with products which were not ordinarily available locally. Merchandise from other towns and countries were brought in by ambulant merchants who travelled from fair to fair. This traffic was the principal type of foreign trade of the period.

The fairs also provided cultural and amusement attractions which served to broaden the limited horizons of medieval man. The prominent fairs of the Middle Ages included the Stourbridge and St. Ives fairs in England; Marseilles, Lyon and Paris in France; and the Leipzig, Frankfurt and Hamburg fairs in Germany. Trading at these fairs was generally unrestricted, in contrast to the prevailing regulation of local town trading.

*The Italian city-states.* The rise of the Italian cities to cultural and economic importance was partially due to the Crusades. These holy wars affected the cities primarily in two ways. Economically, food and supplies were needed by the Crusaders, and the independent cities of Genoa, Florence, Venice, Naples, Milan and Pisa supplied these wants. Culturally, the interchange of ideas, traditions and customs between the East and the West spurred the output of man's mind and spirit.

As a result of its contacts with the East, the West awakened from its long slumber. Extensive trade with the East gave money new importance and barter was slowly replaced by a money economy. Several cities took on special importance in this new development of trade. Genoa had developed commercially in Roman times and the Crusades enhanced its position. It carried on profitable trade with northern Africa, Germany, Flanders, southern France, Asia Minor and Greece. Its later downfall came about as a result of internal dissensions and Venetian competition.

Surprisingly enough another Italian city involved in this growing trade, Florence, located in central Italy on the Arno river was not a seaport. The year 1421 witnessed a turning point in Florentine history when it acquired the port of Livorno and shifted the source of its wealth from manufactures to commerce and navigation. Prior to 1421 Florence had attained international renown for its silks and woollens and later its industry produced jewelry, perfumes, mosaics and glassware. Some of its importance, however, stemmed from finance. Florentine bankers enjoyed a practical monopoly of these operations during the Middle Ages, and foreign royalty often effected loans through them. These bankers performed many functions—deposit, discount, lending, and foreign exchange.

Of all the Italian city-states, Venice was the most important commercially. The origin of the city may be traced to the fifth century barbarian invasion of the Adriatic coast when the inhabitants fled to a group of islands at the head of the Adriatic Gulf. In the beginning these people earned their living by making salt and as fishermen. Venice later sent ambassadors to the East and paved the way for lucrative commerce with this area. In addition to being a focal point for Eastern and Western trade the city also possessed certain manufactures, namely silk, glass and fine weapons.

Venetian commerce was subject to strict governmental control. Exact routes, ports with which to trade, length of the voyage, number of sailors per vessel, make-up of cargoes and prices all came under governmental supervision. As was the case with many Italian cities of the Middle Ages, domestic dissension weakened Venetian power, but its final eclipse may be attributed to the discovery of a new sea route to India via the Cape of Good Hope.

*The Hanseatic League.* In contrast with the cities of southern Europe which were frequently warring with one another, the principal cities of northern Europe chose to unite rather than to fight. Of the many unions formed the most important was the Hanseatic League. Initiated in 1241 when an alliance was formed between Lubeck and Hamburg, the original purpose was mutual protection against piracy. Once piracy had been suppressed, the League members negotiated commercial treaties with various states in order to obtain privileges which ultimately made possible a virtual monopoly in some aspects of the trade with these areas.

As a result of these negotiations the League was given the privilege of incorporating on foreign soil, notably in England and Russia. It became so powerful that it was able to dictate to lords and kings alike on commercial matters and to formulate its own trade regulations. Its trade included wax, hides, corn and leather from Russia, woolen textiles from Germany, iron, timber and fish from Scandinavia, wool, tin, and hides from England and fish, skins, honey and copper from the Netherlands. Internal strife coupled with pressure from the English, Dutch, and Scandinavian countries brought about the downfall of the Hanseatic League in about 1630.

The Hanseatic League may be regarded in some respects as a great commercial state. It had its own parliament, courts, fleets, and army. Vessels of war usually accompanied the merchantmen of the League on their voyages for protection against pirates. The participating merchants did not trade as private individuals but as members of specific merchant guilds, and the privileges which the League gained through its negotiations were available only to the membership of the associated guilds. The Baltic and the North Sea were the principal areas where its members traded.

The merchants of the Hanseatic League prospered and many amassed considerable fortunes. This increase in capital accumulations was destined to play an important role in the development of the capitalist system for, until the emergence of a wealthy trading class, the capital of Europe consisted largely of land and agricultural equipment. The merchant and craft guilds of the medieval cities did not lead to large savings, they afforded their members little more than a living according

to the standards of the day. The funds which the members of the Hanseatic League and the other well-to-do traders of the time were able to amass, however, provided venture capital for the economic expansion of Europe which was to take place later during the Mercantilist revolution.

*Means of payment.* Although coined money was in use in some places the early traders did most of their business on a barter basis. Gold and silver in the form of uncoined bars, exchanged on the basis of weight, were known to the Egyptians and Babylonians some three or four thousand years B.C. In the Mediterranean countries, especially Lydia, coins were used as early as 700 B.C. The mines of Croesus supplied the gold for the coins which this king minted. These early coins were stamped to show their weight and often the weight gave the coin its name. A seal certified to the fact that the pieces were genuine. The use of money was considerably extended by the Persians and the Greeks and the city of Athens organized several monetary leagues with other Greek city-states to consolidate and improve their monetary systems. Money in the form of both coins and paper was used by China at an early date according to the reports of the Venetian traveler, Marco Polo.

During the Middle Ages money was widely employed, some of it was issued by kings, others by important lords and bishops and some by private individuals. The monetary systems of the Middle Ages suffered from several defects. There was a lack of uniformity in the systems and a wide variety of coins of different types, values and condition was in circulation. There was not a sufficient increase in the volume of metallic money to sustain the currency outflows to the East and the increasing industry and commerce of the period. Debasement of the coinage was widely practiced. The diversity of moneys in circulation gave rise to money changers who plied their trade in the principal commercial centers of each country. There was a genuine need for their services, without them the monetary systems would have restricted commerce considerably more than they did.

Because of the relative shortage of money, its value rose while prices fell. These facts help to explain the search for the precious metals, which was a leading motive of the voyages of discovery and exploration which characterized the period of the Mercantilists. Although credit was not extensively employed during the Middle Ages, there was nevertheless some available which was frequently used for purposes of consumption. The Jews, who were forbidden to own land and to enter many of the trades and industry of the day, turned to money lending. Later, the Lombards, Florentines and Venetians, as well as Germans entered the money-lending and banking fields and joined the Jews in this traffic. The Italian bankers, among them the Bardi, Medici, and Peruzzi families,

changed and loaned money, received deposits, and utilized bills of exchange. In Germany the Fugger family, after having built a successful textile business, engaged in international finance on a large scale. Many of these bankers had agencies or branches in the principal commercial centers of Europe, the financial center of London is still known as Lombard Street from the place the Lombard bankers used as the center of their operations.

### The Mercantilist Revolution

In 1453, the Turks captured Constantinople, and this conquest disrupted trade between the East and West. If the thriving trade which Western Europe had developed was to continue, new trading areas and routes had to be discovered. In addition, stories of traders and travelers stimulated interest in traffic with China, India and Africa. At the same time venturesome navigators and explorers sailed to greater and greater distances. In 1492 Columbus sailed to the New World, and in 1499 Vasco da Gama completed a voyage to India around the Cape of Good Hope. In 1497 John Cabot sailed from England and is believed to have reached the shores of Newfoundland by the way of Iceland. The gold which the early explorers brought back stimulated interest in the search for the precious metals and served to promote voyages of discovery and exploration.

*Discovery, exploration and trade* Spain and Portugal took the lead in sponsoring maritime voyages to seek new lands, sources of the precious metals and opportunities for trade. Spain pushed programs of exploration and conquest in the New World during the sixteenth century and was successful in exploiting gold and silver mines in the Western Hemisphere. As a result large quantities of both metals flowed into Spain. Since Spain held most of the mines discovered by European nations and had the largest stock of precious metals, the other nations of Europe faced the problem of obtaining specie from the Spaniards. The means employed consisted of piracy, war and the balance of trade mechanism. Mercantilist authors in England, France and Italy reasoned that if their nations could attain a surplus on their merchandise and services account in trade with Spain and other countries, those countries would have to ship them specie to liquidate their deficits. As a result of the successful application of this theory, the specie which originally flowed into Spain was subsequently distributed among the countries of Europe. The money in circulation in Europe increased and prices rose an estimated 600 per cent during the sixteenth century.

The precious metals were not the only attraction of the new colonies and trading centers. From the Americas, tobacco, corn, beans, quinine, tapioca and potatoes flowed to Europe. That continent exported,

in return, hardware, wheat, powder and cloth. Ruthless colonial policies, administrative mismanagement and the wars of the period led to the decline of Spain's position as the leading European power and colonial empire. Holland, England and France assumed the leadership lost by the Spanish.

*Commercial organization.* The medieval types of business organization were not well adapted to the commerce which grew out of these discoveries and explorations. The new trading ventures required large amounts of capital, far more than most private individuals could afford. Trading voyages took a long time to consummate, sometimes several years. Trade was also dangerous because navigation was still relatively in its infancy. The clumsy vessels did not fare well in foul weather, piracy was rife, and the peoples of the overseas trading areas were not always docile. These conditions made imperative the development of new forms of business adapted to these circumstances.

Fortunately, certain past business institutions provided guides for the development of new forms of enterprise capable of meeting new trading requirements. Among the older forms of business enterprise which had long been used by Mediterranean traders were multiple partnerships with several active partners, the *commenda*, with some active and some silent partners, *respondentia* or cargo loans, bottomry loans on the vessel and other sea loans where the lender would only be repaid or given a share of the profits if the voyage were successful. The notion of the corporation with its separate legal personality and limited liability was also known to the Mediterranean traders. In addition, experience of the Hanseatic League and the medieval guilds showed what could be done by associations of businessmen operating under monopoly conditions.

Institutions for concentrating capital and for meeting other requirements developed from this earlier experience. In England, two principal forms of enterprise arose: the regulated company and the joint-stock company. Regulated companies were associations of independent traders such as the Muscovy Company, the Eastland Company, the Levant Company and the Merchant Adventurers, where the association obtained monopoly rights to the trade of certain specified areas. Members pooled their resources to buy or lease ships and traded under the rules established by the association. Each member of the organization traded on his own account. This form of organization was an improvement over older forms of enterprise, but it was not completely adapted to the needs of the day. Competition was keen among members, no single trader had sufficient capital to exploit adequately the business opportunities offered, internal quarrels and dissension frequently brought about the dissolution of such associations.

An alternative form, the joint-stock company, rose to importance early in the seventeenth century. Under this form of organization an enterpriser or a group of enterprisers created a type of business corporation and invited potential investors to purchase shares in the company. These companies had a monopoly of trade with a given area, and as the regulated companies were dissolved they were granted the monopolies formerly held by the latter as well as rights in new areas. These firms were endowed with a greater degree of corporate personality than the regulated companies. In case of failure the creditors of the company could not call upon the stockholders to pay for losses beyond the amount of their original investment. The shareholders received a proportion of the earnings, they could benefit by the increase in the market value of their shares; they were part owners of a valuable business property.

The emergence of the joint-stock company was an important business innovation. It tapped the savings of large numbers of people and helped to put small accumulations of capital to work in trade. These corporations had perpetual life, gave continuity to business operations and permitted the formulation of long-range business policy. Since an investor could sell his shares, an active market in securities developed in the commercial centers of Europe. These markets later became the stock exchanges which aided in the development of capitalism by providing a mechanism whereby capital could be drawn into and out of business with dispatch and at low cost.

*Money and credit under Mercantilism* As already noted the stock of metallic money increased greatly during the Mercantilist revolution. A new form of money also made its appearance in Europe: credit money. Two sets of circumstances contributed to this development. Transactions of traders frequently involved transfer of large sums of money. Since security and police protection were not well organized, each person was obliged to provide his own protection. Hence, businessmen conceived the idea of depositing their money in certain centers which were well guarded and, when they had debts to discharge, issued written orders on these depositaries to make payment to named individuals. If the payee also had an account with the same depository, transfer was made by debiting the account of the payer and crediting that of the payee. If the payee did not have an account, he could take his order (a form of check) to the depository and receive metallic money in payment.

These depositaries discovered that it was not necessary to maintain all of their deposits in cash. Reserves of 100 per cent were not needed because all of the depositors did not demand repayment at the same time and as payments were made fresh deposits often were also acquired. These institutions started to issue notes, to lend some of their reserves

at interest and found that they were able to remain liquid by maintaining fractional reserves. Thus the principle of reserve banking was born. Banks maintained partial reserves against both their deposit and note issue liabilities. They gradually developed the functions of commercial banks. In England these banks grew out of some of the financial operations of the gold and silversmiths who were well equipped to safeguard deposits of money. In Amsterdam some businessmen created a depositary which later became the Bank of Amsterdam, and in Italy the Bank of St. George traced its origin to similar practices.

From these beginnings, banking spread to many commercial centers of Europe where private banks were chartered. The growth of commercial banking served to increase the amount of credit available and the high interest rates of the Middle Ages declined substantially. Money lending not only became institutionalized, it also became respectable. Canon law prohibitions on interest taking were no longer enforced and were later abandoned. The banks contributed to the amount of capital available and engaged in foreign exchange and collection operations as well as in deposit banking and lending. Thus, in addition to the increase of metallic money, the Mercantilist epoch was characterized by the development of paper money and credit. As one result of the substantial increase in the volume of both metallic and paper money, the commercial revolution was a period of rising prices and declining value of money.

*Industry* The Mercantilist revolution was largely commercial in character and trade was the driving force of the period. Industry, instead of being the bellwether of the movement, was but a follower. The increasing business carried out by the trading companies called for larger outputs of goods to be used as exports and industrial production grew to meet this demand.

The countries of Europe endeavored to outdo one another in the industrial fields. Louis XIV of France, notably, made efforts to entice artisans from Italy and other countries to come to France and establish new industries. Inducements were offered these prospective industrialist immigrants in the way of monopoly, capital and royal patronage. Rival countries soon offered similar incentives. The new industries were organized generally outside of the guild system which was progressively weakened and finally disappeared. Other attempts to foster industry were made by giving royal patents of monopoly to certain individuals, often court favorites, and some industries were encouraged by the investment of royal capital as well.

*Political and social changes.* Gustav Schmoller, in *The Mercantile System and Its Historical Significance*, has termed Mercantilism a system of state-building. The period was characterized by the desire of the rulers

to consolidate their power, to weaken that of the lords, to develop and improve their economies, to increase the wealth and income of the people and to extend their authority over colonial domains. Their approach to these problems was partially negative, partially positive and constructive.

The negative aspects of these efforts centered around the idea that all nations were rivals, that one nation could only or most readily become wealthy at the expense of other nations. Another negative aspect was the attitude of the metropolitan countries toward their colonial possessions which were regarded as outlets for the products of the metropolis and sources of its imports. The efforts of the kings to develop trade and industry within their domains and the discovery and exploration of new lands were constructive approaches to the problem of state-building.

Large profits made in trade and industry served to strengthen the power of the emerging middle class or bourgeoisie. The class which owns or controls the most important productive resources is sometimes held to be the ruling class. Before the commercial revolution the primary resources were land and capital associated with agriculture. These were owned by the aristocracy which was then the ruling class. With the commercial revolution the importance of mercantile and industrial property began to assume a new importance. This growing commercial and industrial capital, owned by the emerging bourgeoisie, aided that class in its long struggle with the aristocracy for power.

In the conflict between landlord and bourgeois, one might think that the kings would have sided with the aristocrats, since they were aristocrats themselves and their attitudes and philosophies were largely those of that group. However, in order to concentrate their own authority the kings felt that it was necessary to weaken that of the landed aristocrats, and consequently they supported the rival group, the bourgeoisie, in its bid for power. The kings were also aware of the fact that the middle class was making a major contribution to the increase in the wealth and income of the realm. The period of Mercantilism therefore marked the beginning of the decline of aristocratic societies and the emergence of those dominated by the middle class.

*Government regulation of economic life* Mercantilism is frequently called the regulated system because of the extensive government controls over business life which were in effect at that time. Mercantilists believed that a nation, like an individual, became wealthy in proportion to the amount of money or specie which it held. Accordingly government regulations were designed to attain an export surplus which was termed a favorable balance of trade and which would be payable in specie by the nations with balance of trade deficits or import surpluses. Some of the regulations took the form of tariffs levied on the imports of manufactured

goods while others encouraged the export of manufactures. Since the Mercantilists did not think that an economy would function in a satisfactory manner without government intervention, they regulated many other aspects of economic activity. Some of the controls which were instituted were favorable to business, especially manufacturers and exporters. Agriculture, labor and the consumer were often sacrificed in what was held to be national interest. In time these regulations provoked a reaction against their excesses and were one of the reasons which led to the ultimate downfall of the system.

*Cultural changes.* The introduction by traders of many new products into Europe was a matter of some significance and served to broaden European culture and to improve the health of the people. Tales of returned traders and travelers and new books dealing with strange lands and other ways of life widened horizons, stimulated the imagination and fostered the spirit of innovation.

Two events which occurred during the commercial revolution tended to reinforce these changes: the Renaissance and the Reformation. They were not primarily economic in character, but they had important effects upon economic life and their repercussions were felt in foreign trade. The Renaissance affected man's intellectual activities, art, literature and science. It had its center of interest in the classics of Greece and Rome and represented a trend away from scholastic philosophy and theology. In the field of literature it represented a renewal of interest in the classics as well as in the creation of new literary forms, in art it was characterized by a shift of interest away from theological scenes to those of actual life, in architecture it fostered interest in lay rather than religious buildings; in science it encouraged reliance upon observation and the development of principles from observed facts rather than by deduction from the works of the Church Fathers or classical authors such as Aristotle.

The Reformation reduced the authority of Catholic Christianity and created rival religious organizations. While the Church was opposed to interest taking, favored the status quo, looked with disfavor upon the accumulation of wealth and favored poverty, the new Protestant sects allowed greater leeway in the pursuit of wealth, the accumulation of capital, the creation of business ventures and contributed to the economic expansion of the commercial revolution by the adoption of more tolerant attitudes toward business activity.

*Effects of the Mercantilist Revolution* Modern capitalism stems from the Mercantilist period with its growth of trade, industry and finance; the emergence of highly capitalized business units; the creation of the modern corporation and bank; the appearance of new trading tech-

niques and the means of financing this trade; the development of new laws and customs of international trade.

At the same time Mercantilist authors developed theories which have enriched the science and the art of economics. They described the role of foreign trade as a stimulator of economic development. Although some of their strictures concerning the advantages of an increased stock of specie were more doctrinaire than scientific, their general position on money was sound and some of their theories concerning the work that it performs recall the later writings of Lord Keynes. The Mercantilists were well aware of the fact that increasing amounts of money might serve to bring about a rise in prices, they understood the advantages of low interest rates, and they opposed the evils of industrial monopoly.

The Mercantilists not only enriched the body of economic theory, but they made contributions to the folklore of capitalism by stressing the advantages of this form of economic organization and by showing what could be expected of it. The rise to power and importance of the businessman began during this commercial revolution. Since the net benefits of international trade could be measured by the balance of trade surplus, businessmen were partially responsible for the increase in the wealth of nations because they contributed to this surplus. The profits of businessmen were a rough measure of their contribution to national wealth. The difference between the value of their imports and exports afforded a rough means of calculating at once their gross profits and the amount they contributed toward the growth of a favorable balance of trade. To a certain extent business profits became synonymous with national prosperity and national wealth was held to grow as profits increased. Without the doctrine of the advantages of a favorable balance of trade some of the prestige and status of business would be wanting today.

### The Industrial Revolution

The Industrial Revolution consisted of the development of machinery to perform the work done by man with hand tools and the application of power, water, steam and electricity to drive the new machinery. It started in England for a variety of reasons. Important deposits of coal were found there. Britain was relatively peaceful compared with the continental powers, its low wages augured well for high profits. England's break with the Roman Catholic Church removed some moral restrictions on business and its early investments in quantity output industries oriented production to the mass markets.

*Beginning of the Industrial Revolution* The Industrial Revolution began with technological advances in the textile industry. The flying

shuttle was devised and made weaving easier and more rapid. The spinning jenny, mule and new carding machines helped the weaving industry by creating cheaper and more abundant supplies of thread. In the ferrous industries new methods of metallurgy were discovered which decreased the cost of iron and steel. Important discoveries in chemistry added new products and created new industrial processes. The invention of the steam engine freed mechanized industry from the necessity of locating close to water power. Little by little mechanical devices were developed in industry to do much of the work formerly performed by hand. New industrial processes were applied to the manufacture of mass production goods destined to be used by the poor and middle classes rather than to the creation of luxury items for the rich alone.

Although the Industrial Revolution got its start in England, it gradually spread from country to country. A number of developments fostered this spread. Toward the end of the Middle Ages, a desire for greater material wealth grew with the rise of the bourgeoisie. People saved more money and invested it in productive equipment. The growth of the joint-stock companies and the rise of the stock exchange facilitated the investment process. Banks made credit easier to obtain and cheaper. Market demand for goods increased with the growth in population, income and the development of overseas markets. The enclosure acts in England released workers from farms who then became available to industry. The development of waterways, canals and river improvements facilitated the distribution and the marketing of the products of industry. In addition, production became concentrated in fewer hands.

*Nature and effects of the Industrial Revolution* While modern capitalism has its roots in the Mercantile system much of its form and character was derived from the Industrial Revolution. One of the essential features of capitalism, the factory system, was the direct product of this revolution. Under that system, the productive unit was a relatively large one and embodied substantial amounts of machinery, equipment and inventory. Workers assembled at this impersonal factory to engage in the productive process, rather than in the small paternalistic shops of the guild master or in their own homes. Considerable amounts of capital were needed to erect and equip a factory which usually was owned by a wealthy enterpriser or business firm. Few workers could become business owners because the required investment usually exceeded their savings. Consequently industrial society divided into two major classes, workers and owners and passage from the former to the latter became increasingly difficult.

Working conditions in the early factories left much to be desired. Wages were low, the working day long, health, sanitary and moral con-

ditions, poor. The women and children employed in certain industries, especially textiles, served to depress wages, alter the character of home life and reduce the status of the worker.

On the other hand the factory system is largely responsible for the increase in income and wealth in countries in which it is found. It has created relatively opulent societies with standards of living far higher than they would have been without it. In addition, it has helped to reduce the length of the working day, and by providing large amounts of capital it has been the principal force making for higher wages. Although it may have started by enslaving labor, with the passage of time it has been the great liberator of labor. Foreign trade has extended some of the benefits of this revolution to countries where it has not taken root through the export of its products as well as by providing larger markets for the new raw materials which these nations produce.

By utilizing relatively heavy investments in capital in proportion to the labor force, the cost curves of many types of industry have been changed from the constant type to the decreasing cost variety. Since these industries concentrate on the production of goods of mass appeal, costs have tended to decline as sales and output increase. In this way a larger volume of goods of greater variety has been made available to a consuming public growing both in numbers and in effective demand. With the advent of the Industrial Revolution, foreign trade became more necessary than ever to supply the market outlets needed by the mass production industries and to establish larger and more varied sources of supply for their raw material requirements. One of the important problems facing those who are working to promote the economic development of underdeveloped areas is to find means of establishing this revolution in these regions.

Under the impact of the Industrial Revolution, as well as in response to the philosophical contributions of eighteenth century thinkers and economic contributions of the Physiocrats and Adam Smith, the regulated system of the Mercantilists gave way and was replaced by a variety of laissez faire systems. The early foreign traders were aided by the Mercantilist regulations, but the new industrialists found them restrictive and felt that they could do better under a system of economic freedom or liberalism. However, in spite of their advantage for the newly-developed industries, the laissez faire systems which followed Mercantilism did not endure for long because of the impact of the decreasing cost type industries. These industries did not thrive under the finely-divided competition which laissez faire provides, because often no one producing unit gained a large enough share of the market to obtain the full advantage of decreasing costs. In the United States, after the Civil War, large

industrial firms were formed and smaller enterprises were merged or absorbed by the larger ones or were eliminated because they were not sufficiently large to benefit fully from the economies of size. *Laissez faire* became the victim of industrial technology and was partially replaced by monopoly, oligopoly, imperfect and monopolistic competition.

When competition disappears some form of economic regulation must be found to take its place. Consequently government intervention in economic life has increased. In addition the abuses of the factory system required reform and governments passed legislation designed to correct them. The division of industrial society into classes, the concentration of industry and the defects of the early factory system were weaknesses of the capitalistic system which the socialists and Communists, especially Marx and Engels, were able to exploit. Although the present capitalist system bears little resemblance to that which prevailed at the time of Marx and Engels, its accomplishments and its improvement are not widely enough known and socialism has remained a highly exportable product.

We are still living in the Industrial Revolution. It shows no signs of coming to an end. Although it may be possible to distinguish different phases of the movement its essential features are present in each one. We have made more progress in industrialization in recent years than at any time in the past, and the future of increasing industrialization with its many benefits appears to be bright indeed.

### Foreign Trade of the United States

The early trade of the American colonies was carried out under Mercantilist policies and oriented to the greater benefit of Britain than that of the colonies themselves. The colonies exported tobacco, timber, naval stores, furs, skins, fish and leather and imported manufactured goods. The excesses of British Mercantilism ultimately led to the American Revolution which temporarily disrupted the trade of these colonies. The colonies had learned some lessons from Mercantilism, however, and after the Revolution the Constitution of the new republic created one large trading area among the American states. Especially important from the point of view of international trade were the prohibitions which this Constitution placed upon the levying of export duties by the federal government and upon the use of export and import tariffs by the several states.

During the Napoleonic wars from 1779 to 1804 the trade of the United States prospered. This country supplied goods and raw materials to the belligerents and much shipping was carried by American vessels. American shipping declined with the enactment in 1804 of restrictive

trade measures by France and Great Britain. Friction developed between Great Britain and the United States which culminated in the War of 1812. At the conclusion of this conflict American trade again expanded and there were substantial increases in both exports and imports. Between 1816 and 1821 United States trade contracted as a result of the decline in its European wartime markets and the troubled conditions of the times. U.S. foreign trade increased slowly between 1830 and 1850, with imports growing and varying with changes in national income and exports climbing as its industrial and agricultural output developed. This growth continued after 1850 until the Civil War. Cotton, principally of Southern origin, constituted a major export along with manufactured products from the northern states. The international trade of the United States declined markedly during the Civil War. The westward movement, however, opened up new agricultural lands, improvements were made in agricultural technology, and after the war the United States experienced a continued growth in its foreign trade.

While the balance of trade on the United States merchandise accounts was generally in deficit up to 1874, in that year the U. S. had a surplus on these accounts which it has since retained in all years except 1888 and 1889. The period from 1890 until the outbreak of World War I in 1914 was characterized by further increases in foreign trade and by the emergence of the United States as a first-class trading power.

World War I disrupted international trade but during the war years American exports increased substantially as the U. S. furnished the Allies with badly needed supplies. Much of its large export trade during that conflict and the years immediately following was financed by government loans. Heavy exports continued in 1919 and 1920 to aid European reconstruction but declined during the depression years of 1921-1923. After this depression foreign commerce of the United States increased, but the Great Depression of the thirties witnessed a very large decline in its trade. Since this depression was world-wide in scope and affected all industrialized nations, many of the stricken countries took measures to increase their trade artificially by devaluing their currencies, installing import and exchange controls and negotiating bilateral trade agreements. The United States devalued the dollar by 59.06 per cent in 1934 and in 1930 passed the Hawley-Smoot tariff, the most restrictive and protective in its history. These restrictive measures were not successful, however, in substantially raising the levels of international trade.

The anti depression devices employed by the United States under the New Deal as well as some of those used by other nations proved more successful and beginning in 1933 trade improved. But the Great Depression did not finally come to an end until the outbreak of World War II.

in 1939. During this war and under Lend-Lease, United States exports soared while its imports lagged. These exports declined during the immediate post-war months, but in 1947 they again turned upward. Imports maintained relatively high levels all through the period. The Marshall Plan and its successor programs sustained the foreign trade of the United States during the post-war period, and as the European economies gained strength U. S. trade continued to grow with imports increasing more rapidly than exports.

The pattern of international economic relations has seldom remained stable for long. Country after country has risen to importance in the field of international trade. Today the United States finds itself in a position of leadership and occupies a place formerly held in modern times by the British, Dutch, Portuguese and French. Although the United States is a leader in foreign trade, since the Civil War this nation has not occupied a predominant position in the ocean carrying trades. Smaller nations such as the Netherlands and Norway have done better. Subsequent chapters of this book will discuss the role of the United States as a manufacturer, trader and world banker. More specifically, Chapter 11 will describe the recent diverse patterns, directions and trends of United States trade.

### QUESTIONS AND PROBLEMS

1. Comment on the statement that trade is as old as recorded history.
2. Were economic life and foreign trade stagnant during the Middle Ages?
3. What factors account for the substantial growth in foreign trade under the Mercantile System?
4. What were the principal effects of the increase in metallic and credit money during the Mercantile Revolution?
5. Describe the trade of (a) the Italian city-states and (b) the Hanseatic League.
6. Why was there government regulation of business under the Mercantile System?
7. Sketch some of the effects which the Industrial Revolution had upon international trade.
8. Explain the abandonment of government regulations in favor of laissez faire which occurred after the Industrial Revolution.
9. List changes in the business unit which occurred during the period of the Mercantilists.
10. Explain the growth of monopoly after the Industrial Revolution.
11. What were the contributions of (a) Mercantilism and (b) the Industrial Revolution to the development of modern capitalism?
12. Trace the growth of United States foreign trade since the nation's founding.

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## The Balance of Payments: Its Meaning and Structure

Analysts prepare tabulations called balances of payments to present a picture of a nation's economic relationships with the rest of the world or with another nation or group of nations. These statistical compilations are a basic tool of analysis and provide the framework for the elaboration of theories of international trade as well as for the study of its impact on internal and external economies. International economics may be said to begin and to end with these statements.

### Nature and Uses of Balance of Payments

The balances of payments may be defined as *statistical tabulations of economic transactions between residents of one country and the residents of the rest of the world, another country or group of countries*. They present magnitudes showing, in tabular form, the results of all of the foreign transactions of a country during a given period, usually a year or a quarter, and group them into certain relatively homogeneous categories. Table 3.1 shows the balance of payments of the United States with the rest of the world in two recent years.

*Description of balances of payments.* Lines 1-23 on the table present the transactions in merchandise and services which, when grouped together, are usually called the *current account*. Since a substantial amount of these items is transferred under government military grants, a separation is made between military transfers and the others so as to distinguish those financed by the government from commercial transactions. The principal breakdowns of the current account consist of merchandise, transportation, travel, miscellaneous services and income on investments. The account, *miscellaneous services* is a "basket" classification including a number of items each of which is too small to warrant

separate listing. The more important items in this account are communications, insurance and reinsurance, motion picture rentals, engineer's and contractor's services, home office charges and the foreign representational expenses of the United States government. The account, *income on investment*, is included as a services transaction according to established practice although a good case could be made for creating a separate balance of payments category for it since income is not a service transaction in the strict sense of the term.

The account, *unilateral transfers*, lines 24-29, includes transactions for which there is no *quid pro quo* and consists largely of immigrant remittances to family and friends abroad, transfers of funds and goods overseas by religious, welfare, educational and scientific organizations together with government grants and aid to other nations. In the early balances of payments published by the International Monetary Fund and by some other countries, this account was called *donations*. Since 1961 the Fund has employed the term *transfers* to characterize it.

Lines 30-47 comprise the *capital accounts* with two major divisions, United States and foreign capital. Transactions in capital belonging to United States residents are included in the *United States capital account*, those in foreign resident-owned capital are entered as *foreign capital*. The balance of payments also distinguishes *private* from *government capital* movements, as well as *short-term capital* (which consists of capital instruments having a maturity of one year or less) from *long-term capital* maturing in more than one year or with no maturity date. Other divisions of the capital accounts comprise *direct investments* in branch or subsidiary offices and plants abroad and various types of *portfolio* or capital represented by securities.

The account, *gold and convertible currencies* held by U. S. monetary authorities, line 48, refers to the monetary gold held by the United States Treasury and the currencies of foreign countries which the government acquired principally from the sales of surplus agricultural commodities to countries which paid for them in their own currency rather than in dollars. Line 49, *reductions in gold and convertible currency holdings*, is not actually an account but an analytical item consisting of the algebraic sum of lines 45-48, and is included to facilitate the analysis of balance of payments surpluses and deficits. *Errors and omissions*, or as it is sometimes called *unrecorded transactions*, line 50, is a balancing item employed to bring the debits and credits to equal each other. It arises from errors made in preparing the tabulation, from unrecorded transactions which do not come to the attention of balance of payments statisticians and from the transfer of United States currency abroad from one foreign nation to another. The memorandum items I, II and III at the bottom of

TABLE 3.1

## U. S. BALANCE OF PAYMENTS, 1959 AND 1960

(In millions of dollars)

## CURRENT ACCOUNT

Line	Type of Transaction	1959*	1960*
1	Exports of goods and services	25,683	29,065
2	Goods and services transferred under military grants, net	1,974	1,765
3	Goods and services excluding transfers under military grants	23,709	27,300
4	Merchandise, excluding military	16,282	19,409
5	Transportation	1,646	1,816
6	Travel	902	968
	Miscellaneous services.		
7	Private	1,390	1,413
8	Government, excluding military	144	154
9	Military transactions	302	335
	Income on investments.		
10	Direct investments	2,228	2,338
11	Other private	466	518
12	Government	349	349
13	Imports of goods and services	23,537	23,327
14	Merchandise, excluding military	15,294	14,722
15	Transportation	1,759	1,942
16	Travel	1,610	1,744
	Miscellaneous services.		
17	Private	633	634
18	Government, excluding military	302	308
19	Military expenditures	3,109	3,048
	Income on investments		
20	Private	549	597
21	Government	281	332
22	Balance on goods and services	2,146	5,738
23	Excluding transfers under military grants	172	3,973

## UNILATERAL TRANSFERS

24	Unilateral transfers, net [to foreign countries (-)]	-4,398	-4,254
25	Excluding military transfers	-2,424	-2,489
26	Private remittances	-575	-633
	Government*		
27	Military grants of goods and services	-1,974	-1,765
28	Other grants	-1,633	-1,641
29	Pensions and other transfers	-216	-215

## CAPITAL TRANSACTIONS

30	U. S. capital, net [increase in U. S. assets (-)]	-2,728	-4,965
31	Private, net	-2,375	-3,856
32	Direct investments, net	-1,372	-1,694
33	New issues of foreign securities	-624	-573
34	Redemptions	95	100
35	Transactions in outstanding foreign securities	-140	-177
36	Other long term, net	-257	-200
37	Short-term, net	-77	-1,312

TABLE 3.1 (Continued)

Line	CAPITAL TRANSACTIONS (Continued)	1959*	1960*
38	Government, net	-353	-1,109
39	Long-term capital	-1,051	-1,213
40	Repayments	1,054	631
41	Foreign currency holdings and short-term claims, net [increase (-)]	-356	-527
42	Foreign capital, net [increase in U. S. liabilities (+)]	3,721	2,427
43	Direct investments in the U. S.	84	8
44	Other long-term investments in the U. S.	471	289
45	Foreign purchases of U. S. Government bonds and notes, net	686	127
46	Increase in U. S. short-term liabilities to foreign banks and official institutions	2,226	2,107
47	Increase in other U. S. short-term liabilities	254	-104
48	Gold and convertible currencies held by U. S. monetary authorities [U. S. sales (+), purchases (-)]	731	1,702
49	Reductions in gold and convertible currency holdings (line 48) and increase in U. S. short-term and other liquid liabilities (lines 45-47)	3,897	3,832
50	Errors and omissions and transfers of funds between foreign areas [receipts by foreign areas (-)], net	528	-648
MEMORANDUM ITEMS			
	Memorandum items		
I	Increase in reported total foreign gold reserves and liquid dollar holdings	4,591	4,173
II	Through estimated net receipts from, or payments (-) to the U. S.	3,863	3,798
III	Through other transactions	728	375

\* Revised.

Source U. S. Department of Commerce, Office of Business Economics.

the tabulation are not balance of payments accounts, but are calculated from these accounts to show the changes in the foreign holdings of gold and liquid dollars as an aid to the study of balance of payments surpluses and deficits.

The balance of payments shown on Table 3.1 might be termed a compilation of *basic data*, and that is the term which the International Monetary Fund uses to characterize this type of tabulation. Several other forms of balance of payments presentation are employed, but all of them are derived from the basic data. The actual form used depends upon the purposes which the tabulation is designed to serve. Another form, Table 3.2, presents an analytical balance of payments of the United States for 1959 and 1960 and is designed to show surpluses and deficits on the several accounts. Other balances of payments, both basic and analytical, of the United States and other countries are presented and discussed in Chapters 5 and 6.

TABLE 32

## ANALYSIS OF U S BALANCE OF PAYMENTS, SEASONALLY ADJUSTED

(Millions of dollars)

	1959	1960
U. S. payments	29,743	31,412
Imports:		
Merchandise	15,294	14,722
Military expenditures	3,109	3,048
Other services	5,134	5,557
Remittances and pensions	791	848
Government grants and capital outflows	3,040	3,381
U S. private capital	2,375	3,856
U S receipts	25,318	26,228
Exports		
Merchandise	16,282	19,409
Services	7,427	7,891
Repayments on U S Government loans	1,054	631
Foreign long-term capital	555	297
Excess of receipts or payments (-)	-4,425	-3,184
On goods and services	172	3,973
On Government grants and capital	-1,986	-2,750
On private U S and foreign long-term capital	-1,820	-3,559
Unrecorded transactions	528	-648
Total, net receipts (+) or payments (-)	-3,897	-3,832
Major special transactions [receipts (+), payments (-)]	335	-524
Total, excluding special transactions	-4,232	-3,308

Source: U S Department of Commerce, Office of Business Economics

*The principle of residence* The test of whether a transaction is international or not is not a question of the physical movement of goods, services and capital from one country to another but the place of residence of the parties to it. Transactions entered on the balance of payments are exclusively those which are consummated between the residents of different countries. An international transaction may be defined as the transfer of assets and liabilities, the creation or the reduction of claims or the receipt and payment of funds which take place between the residents of different countries.

It is possible to define resident in a variety of ways. For balance of payments purposes, individuals are generally considered to be residents of the countries in which they ordinarily live. People who live or who are employed temporarily in a country are usually not considered residents of that country but of their own country. Citizens who work overseas for their governments are considered residents of their home country regardless of how long they remain abroad. A corporation is considered a resident of the country in which it is incorporated no matter who owns its stock. The foreign branches of business firms abroad are held to be

residents of the countries in which they operate regardless of the residence of the firm which owns them.<sup>1</sup>

Thus the purchase by an American resident of real estate in London owned by an Englishman is an international transaction although the real estate is not moved to the United States. The transfer of funds in international transactions does not necessarily involve the physical movement of the funds, the transfer of ownership between the residents of different countries is often made by debits and credits on books of account. The purchase of food and lodging by American tourists in France is a United States import, although both the food and lodging are consumed in France. There is, however, a transfer of ownership of the food and lodging from French to American residents.

*The balance of payments and the national accounts.* The balance of payments forms part of the national or social accounts of a nation. These statements present the several national income and product accounts which show the output of an economy and its distribution in the form of income shares. In the national product accounts, the economy is classified into consumption, domestic investment, net exports of goods and services and government purchases of goods and services. The national income accounts are divided into compensation of employees, proprietors' income, rental income, corporate profits and net interest. The activity of the economy is represented by a series of flows of product and income among these several sectors.

These accounts are based upon a double-entry system of accounting. The balance of payments represents a fuller development of the national product account, *net exports of goods and services*, or as it is sometimes called *net foreign investment*. All the national income and product accounts, including the balance of payments, are *aggregates* and their analysis is *aggregative analysis*. They are tools of macroeconomics rather than microeconomics.<sup>2</sup>

*Nature and sources of balances of payments* The balance of payments is one species of a large genus which presents the relationships

between any one sector of an economy and the others. The balance of payments species shows the relationships existing between a national economy and the rest of the world or certain specified countries. It indicates what is sent to foreign nations and what is received from them in return.

It would be theoretically possible to tabulate other species such as the relations between agriculture and the rest of the economy; to show what workers give and what they obtain, to prepare data indicating what a firm contributes, and what it derives from the rest or from certain segments of the economy.

The balances of payments of the United States are published periodically in the *Survey of Current Business* and its *Supplements* of the United States Department of Commerce. They are frequently analyzed in the *Federal Reserve Bulletin* of the Federal Reserve Board. The *Monthly Reviews* of the several Federal Reserve Banks, especially that of the Federal Reserve Bank of New York, also publish analyses of them from time to time. The balances of payments of members of the International Monetary Fund are published annually in the Fund's *Balance Of Payments Yearbook*. Official publications of other governments' periodically present their balances of payments.

The United States Department of Commerce compiles balance of payments statements with the rest of the world for each year and for each quarter. These might be termed global presentations. As such they show the over-all results of United States trade with all nations. These statements do not tell where our trade is moving, the principal countries which buy our exports and supply our imports, where Americans are investing abroad or what countries are investing in our enterprises. They do not indicate increases and decreases in items for one country which are offset by decreases and increases in another. Like all totals, transactions with the rest of the world hide many interesting and important details. To remedy this defect the Department of Commerce compiles "bilateral" balances of payments between the United States and certain countries or related areas such as the United Kingdom, the Sterling Area, Western Europe including the Western European dependencies, Canada, the Latin American Republics, all other countries, and international institutions.<sup>3</sup>

*Uses of the balance of payments* The balance of payments provides basic data in logically organized form for the quantitative analysis of international trading relationships as well as for the formulation of

<sup>3</sup> A list of countries and organizations included in each group is given in *Balance of Payments Statistical Supplement*, Department of Commerce, Washington, D C. U S Government Printing Office, 1958, pp. 6-7.

judgments concerning the significance and results of foreign trade. As a tool of economic analysis, it indicates how the goods, services and capital received from abroad are paid for and how foreign nations paid for the things that they received. It shows whether or not sales of merchandise and services to foreigners were sufficient to pay for the goods and services purchased from them and, if they were not, what means were employed to pay for them. The amount that investments abroad brought in terms of income receipts and the amount of income that was paid foreigners for their investments here can likewise be determined from them.

Some of the effects of our government unilateral transfers of economic and military aid to foreign countries can also be estimated from these data. The compilations likewise show the relationships between the movements of short-term capital and other transactions and indicate the net amount of gold and foreign exchange received or paid out as a result. When a nation has determined what it sent abroad and what it received in return, judgments can be made concerning the significance and value of foreign trade.

Table 3.1 does not indicate the *total* amount of money which Americans have invested abroad or the *total* amount of gold which we have on hand and which was supplied by foreigners. In this respect the balance of payments resembles a business income or operating statement rather than a balance sheet, because it reflects only the *movements of the accounts for a stated period* rather than cumulative totals and presents only the results of the activities which took place during that period.

### Business and Balance of Payments Accounting Contrasted

*Debits and credits* The balance of payments, like double-entry accounting, is composed of debits and credits, usually represented by plus (+) signs, or no signs at all for credits, and minus (−) signs for debits.<sup>4</sup> The total debits which it carries equal the total credits; the tabulation "balances out" like any accurately kept set of accounting records. If the accounts are not in balance, an error has been made.

As is usual in mathematical work, where a magnitude carries no sign it is assumed to be a positive (+) value and in balance of payments practice it is a credit. Where it has a negative value it carries the sign (−) and is a debit in the balance of payments terminology. In practice, however, there are some exceptions to this rule as an examination of Table 3.1 shows. In the current accounts in this table, the exports (items 1-12) carry no sign and they are positive (+) entries or credits. The

<sup>4</sup> In balance of payments accounting the positive (+) and negative (−) values are the reverse of those used in commercial accounting in some cases.

imports (items 13-21) likewise carry no sign although they are negative values (-) or debits. The compilers of the balance of payments tacitly assume that readers of these compilations realize that imports are debits and they feel that it is not necessary to employ the negative sign.

*Netting out.* The current account on this tabulation is the only one in which both the total debits and credits are shown, the exports are the credits and the imports the debits. All of the other accounts are "netted out," that is, they only show the algebraic sum of the debits and credits entered. Thus, for example, if the debits to United States capital amounted to -\$1,326 million and the credits to \$1,000 million, only the net result, -\$326 million, is shown on the statement. On all of these accounts, items 24-50, we have no means of knowing the total amount of either the credits or debits. Given the type of records maintained by financial and business firms from which the balance of payments data are obtained, it would be difficult and expensive for these firms to furnish the totals for all debits and credits, so only the net amounts are given.

This practice has certain disadvantages for the empirical analysis of these statements because it is impossible to ascertain the total outflow and the inflow of the accounts in question, only the net amount of the transactions is known. For instance, if the total payments on the unilateral transfers amounted to \$5,001 million and the total receipts to \$5,000 million, the account would show a net debit of but one million dollars which is hardly representative of the magnitude of the transactions which took place during the period.

*Methods.* Although the principles of business accounting are utilized in balance of payments work, the same methods are not. Business accounting systems are arranged so that every transaction passes through the books and is recorded. They are designed to be effective in properly entering every transaction in the appropriate account and to do this as directly and economically as possible. Obviously, business management can arrange for such systems because it controls a firm's operations and policies. Since the United States is not a business enterprise and its government keeps but relatively few international accounts of its own, its balance of payments statisticians frequently must rely upon the records kept by others.

True, some government records can be utilized with but little change for balance of payments work; records such as import and export statistics and those arising from the international transactions of the federal departments and agencies are of this type. In other cases, federal reporting requirements oblige business firms to prepare special tabulations and reports from their records to provide usable data for government purposes. The Treasury Department and the Federal Reserve Board,

among others, require such records from certain banks, financial dealers and institutions. In other cases data are obtained from questionnaires, forms, special reports and correspondence while some are estimated from tabulations prepared for other than balance of payments work.

In a very few cases, no records are available, no estimates are prepared and some transactions do not find their way into these tabulations. This does not mean that these compilations are neither representative nor reliable. They are both, and the methods of their elaboration are constantly being improved.<sup>5</sup>

### Debits and Credits—The Assets and Liabilities Approach

As far as the balance of payments is concerned, the type of transaction depends upon the country preparing the tabulation. An American export of goods to the United Kingdom, for example, is an import to the compilers of the British balance of payments. A purchase by Americans of portfolio securities in France is an outflow of United States capital to U.S. Department of Commerce statisticians and an inflow of capital to French analysts. The transactions of one country should, theoretically, find their counterpart in those of the country with which the transaction was consummated.<sup>6</sup>

Three approaches to balance of payments debiting and crediting are commonly employed: (1) assets and liabilities, (2) claims, and (3) receipts and payments.

In double entry accounting there are least two entries for each transaction: a debit and a credit. In accounting, for example, if merchandise is sold for cash, the merchandise account is credited and the cash account is debited for the amount of the transaction. If merchandise is purchased on open account, the merchandise account is debited and the accounts payable are credited for the amount involved.

International accounting debits and credits are often viewed<sup>7</sup> as in commercial accounting from a balance sheet point of view. A balance sheet consists of assets (debits) and liabilities (credits). Except for gifts,

<sup>5</sup> For other balance of payments methods see: The International Monetary Fund, *Balance of Payments Manual* (Washington, D.C., 1961), Bulger, Donald G., "The Balance of Payments: A Tool of Economic Analysis," *International Monetary Fund Staff Papers*, II (Sept. 1951), pp. 86-197.

every international transaction (including services, as a kind of intangible asset) involves a change in assets or liabilities.

*In balance of payments tabulations, every increase in an asset must be accompanied by a decrease in another or an increase in a liability. A decrease in an asset must find its counterpart in an increase in another or a decrease in a liability.*

*Conversely, every increase in a liability occasions a decrease in another or an increase in an asset. A decrease in a liability calls for either an increase in another or a decrease in an asset.*

*In balance of payments accounting, increases in assets and decreases in liabilities are debits. Decreases in assets and increases in liabilities are credits.*

**Payment for transactions** Just as in domestic trade, every sale, purchase or investment in international trade must be paid. There are, therefore, debits and credits to the merchandise, services, unilateral transfer and capital accounts arising from the purchase or sale of these items and counterbalancing debits and credits to the accounts used as means of payments. These accounts are generally, but not always, the short-term capital accounts, for they are the cash or "checking" accounts used in international payments. Some transactions do not involve cash payments. an import of merchandise may be paid for by an export of merchandise, an investment overseas may be consummated by exchanging capital stock, and unilateral transfers are not paid for at all.

Many international business transactions involve more than two entries. A capital investment requiring both cash and equipment would entail at least three entries, one for the investment itself, one for cash, and one for merchandise. Complex transactions covering several balance of payments items would entail a number of entries. The principle, though, is clear, the total amount of all the debits must equal all the credits regardless of the number of transactions.

Most foreign business is financed by the use of short-term capital which consists of bank balances, bills of exchange or drafts, notes and other claims as well as currency and accounts receivable and payable. Debits and credits arising from merchandise and services exports and imports, cash gifts, long-term capital movements and others frequently find their counterpart in counterbalancing entries to the short-term capital accounts.

To finance foreign trade United States banks maintain deposit balances (U. S. assets and foreign liabilities) with correspondent or branch banks abroad. These balances are usually denominated in the (foreign) currencies of the countries in which they are located. Conversely, foreign banks maintain deposit balances (U. S. liabilities and foreign assets) in

United States branch or correspondent banks which are generally denominated in dollars. Foreign traders may purchase drafts drawn by domestic banks on their foreign balances to pay for their overseas purchases and sell to these banks, against payment in their local currency, the proceeds in foreign currency of their overseas sales.

In addition, bill and note brokers and dealers as well as financial institutions in the United States have "holdings" of bills and notes drawn on foreign banks, business firms and individuals, usually in foreign currency (U. S. assets and foreign liabilities). Foreign dealers, brokers and banks, conversely have holdings of notes, bills and claims drawn on United States banks, firms and individuals, generally denominated in dollars (U. S. liabilities and foreign assets). Both American and foreign dealers offer their foreign exchange for sale and stand ready to purchase exchange from those who desire to dispose of it. Both banks and foreign exchange dealers make a profit from selling exchange at a slightly higher price than they pay for it.

Certain foreign exchange brokers do not buy and sell exchange themselves but do a strict brokerage business bringing buyers and sellers, usually banks, of exchange together. They are paid a commission on all transactions which are consummated as a result of their activities. Some foreign trade is also done on an open account basis, as in domestic trade, giving rise to accounts payable and receivable.

*Transactions as changes in assets and liabilities* When short-term United States dollar assets, balances, holdings, accounts receivable, or currencies are owned by foreigners they are United States liabilities, and when foreign currency holdings are owned by United States residents they are United States assets. Applying the rule stated above, an increase in assets or a decrease in liabilities is a debit, a decrease in assets or an increase in liabilities is a credit.

An export of merchandise is a decrease in a country's assets—stock of goods—and a credit. An import of merchandise is an increase in a nation's assets and a debit. An export or sale to a foreign resident of a service such as transportation or travel, represents a decrease in intangible assets and is a credit. Conversely, an import, or purchase of a service, increases intangible assets and is a debit.

If the export is paid for from foreign-owned holdings of the exporting country's currency, there is an offsetting reduction in the exporting country's liabilities to foreigners and a debit entry. If the export is financed on credit, or by accepting payment in the currency of the importing country, the offsetting entry is an increase in the exporting country's assets and is a debit entry.

If an import is paid for in the importing country's holdings of the

currency of the exporting country, there is a reduction in the importing country's assets—a credit. Should it be financed on credit, or by making payment in the currency of some other foreign country, the offsetting credit is an increase in the importing country's liabilities or a decrease in its assets.

When the residents of one country invest abroad, their investments may consist of funds, equipment, supplies or assets such as patent rights. Such investments, if they have an original maturity of over one year, are long-term capital movements and are debits, because they are increases in the investing country's assets held abroad. These assets are usually either stocks and bonds of foreign enterprises, interests in, or ownership of, subsidiaries and branches abroad.

If the investment takes the form of a transfer of funds, the transfer either reduces the investing country's short-term assets, its holdings of foreign currency, or it increases its short-term liabilities or foreign country's holdings of its currency and, in either case, is a credit. Should the investment be in merchandise or services, the transfer is a merchandise or service export, and a credit, because it reduces the exporting country's assets.

In the country which receives these investments, the opposite entries are made. The properties acquired by foreign investors are reductions in the recipient country's assets, or increases in their liabilities, and are credits. The transfer of the funds themselves, the counterbalancing entry, would usually serve to increase the recipient country's holdings of foreign currencies or assets and would be a debit. If the investment were made in merchandise or other assets, the shipments would be an import or debit from the point of view of the recipient country.

The import of gold is a debit entry since it increases the assets of the importing country. The payment for the gold could be made in several ways. The gold importing country could pay in its own currency thereby increasing its liabilities, or, in the currency of the gold exporting country thereby decreasing its assets. Both of these transactions could be credits.

A gift, or unilateral transfer, requires a debit entry for the country making the gift. This debit offsets the credit which the gift created—a credit to exports if the gift were in the form of merchandise or services, and a credit to one of the short-term capital accounts if it were in cash.

### Debit and Credits—The Claims Approach

As an alternative to the assets and liabilities approach, students of international economics sometimes view the effect of the transaction

on the balance of payments as creating, increasing, decreasing or cancelling the claims of one country upon another.

*Those items which give rise to, or increase, claims for payment by residents of one country upon residents of others are credits for the country owning the claims and debits for the country which owes them.*

*Any action that cancels or reduces a claim for payment upon foreign residents is a debit for the country whose claim is cancelled or reduced, and a credit to the country making the reduction.*

From this point of view, United States exports of merchandise and services are claims for payment against the foreign importers and are credits. United States imports of goods and services, on the other hand, are claims for payment by foreigners and are debits. United States long-term capital investments abroad are debits because the foreign recipients of these investments have claims for payment of the investment. Conversely, foreign long-term capital investments in the United States are credits. United States residents have claims upon foreigners for payment.

Other claims arise when an export, import or investment is paid. If a foreigner pays for a United States export or for his capital investment in the United States by a draft on his bank, the United States resident's claims for payment are cancelled and the transaction is a debit on the United States balance of payments. When United States importers or investors in foreign enterprises pay their obligations, foreigner's claims are cancelled and the transactions are credits in the United States balance of payments.

Gifts of merchandise constitute an exception to these rules. A gift gives rise to no claim for payment. In these unilateral transfer cases, the unilateral transfers account is debited. The shipment of merchandise as a gift is an export of goods and is a credit, counterbalancing the unilateral transfer debit. Conversely, a gift of merchandise by foreign to United States residents is an import of merchandise and a debit, unilateral transfers are credited for the value of the import.<sup>7</sup> Gifts of money in the form of checks, drafts, bills and international postal money orders do give rise to claims for payment because they must be paid when due. When a resident of the United States sends a gift check or draft to relatives or friends abroad, it is a debit to unilateral transfers, and the check, draft or money order cancels the foreigner's claim and is a credit.

## Debits and Credits—The Receipts and Payments Approach

In recent years there has been a tendency to reduce the emphasis on the analogy between balance of payments and commercial accounting, to rely less upon the concept of debits and credits and to substitute the concept of *receipts and payments*. From this point of view, a debit is an international payment and a credit an international receipt. An increasing number of balance of payments statisticians deal primarily in terms of receipts and payments.

*An international transaction which gives rise to a flow of funds into a country is a receipt for that country, one which gives rise to a flow of funds out of a country is a payment for that country.*

*Payments are treated as debits and are entered as assets on the balance of payments, receipts are treated as credits and are entered as liabilities.*

An export of United States merchandise or services to a foreign country is a receipt because it gives rise to a flow of funds into the United States. A United States import of goods or services means a flow of funds out of the country and is a payment. American investments in other countries are payments, because there is an outflow of funds to the country in which the investment was made. Conversely, foreign investments in the United States are receipts because there is an inflow of funds from the country making the investments. A unilateral transfer or a gift of cash is an outflow or payment for the country making the gift. A unilateral transfer or gift of merchandise or services, although it does not involve the flow of any funds, is nevertheless regarded as a payment for the country making the payment.

Short-term capital inflows and outflows are likewise receipts and payments. When foreign short-term capital enters, or American capital returns to, the United States, there is a receipt. There is a payment when U. S. short-term capital flows abroad, or foreign capital returns from America. Reductions in foreign balances or holdings in the United States are regarded as receipts, reductions in U. S. holdings abroad are payments.

Following these rules, certain transactions normally give rise to liabilities, credits, or receipts on the United States balance of payments and others to assets, debits, or payments. In interpreting the lists which follow, it should be remembered that a resident may be a person, firm, institution or government.

### Representative United States Liability, Credit or Receipts Transactions

Each of the following transactions is a credit. It decreases United States-owned assets, or increases United States liabilities, constitutes a

claim upon residents of foreign countries and gives rise to a receipt of funds.

*Credit Item No*

7  
1-4

1. Merchandise exports.
2. Expenditures of foreign travelers in the United States.
3. Transportation services rendered by United States companies to foreigners for freight or passenger transport.
4. Reinsurance premiums and payments made by foreign residents to United States resident insurance companies.
5. Interest, dividends, rents and profits paid by foreigners to United States residents
6. Fees paid to United States contractors and engineers by foreigners.
7. Film rentals, patent, copyright and trademark royalties paid to United States residents by foreigners
8. Gifts of cash, merchandise or services made to United States residents by foreign residents
9. Purchases of property belonging to United States residents by foreigners
10. Sales of United States resident-owned or issued securities to foreign residents
11. Direct investments which carry a managerial interest in business firms, branches and subsidiaries located in the United States by foreign residents
12. Increases in deposits and balances in United States-located banks and other financial institutions owned by foreign residents
13. Increases in foreign-owned holdings of drafts, bills, checks, currency, accounts receivable and other short-term claims payable by United States residents.
14. Decreases in the United States resident-owned claims, deposits and balances in banks and other financial institutions located abroad.
15. Decreases in United States-owned holdings of drafts, bills, checks, accounts receivable, currency, and other short-term claims payable by foreign residents
16. Repayment by foreign governments, firms and residents, of United States government agency loans.
17. Sales of United States-owned gold, or reductions in the United States monetary gold stock.

### Representative United States Asset, Debit or Payments Transactions

Each of the following transactions is a debit. It increases United States-owned assets or decreases United States liabilities, constitutes a claim by foreign residents and gives rise to a payment of funds.

#### *Debit Item No.*

- 1 Merchandise imports
- 2 Expenditures of United States travelers abroad.
- 3 Transportation services rendered by foreign companies to United States residents for freight or passenger transport.
- 4 Reinsurance premiums and payments made by United States residents to foreign insurance companies
- 5 Interest, dividends, rents and profits paid to foreigners by United States residents
- 6 Fees paid to foreign contractors and engineers by United States residents
- 7 Film rentals, patent, copyright and trademark royalties paid by United States to foreign residents
8. Gifts of merchandise, services, money, or claims to money, made by United States residents to foreign residents.
- 9 The sale to United States residents of property owned by foreigners.
- 10 Purchases by United States residents of foreign-owned securities.
- 11 Direct investments by United States residents which give a managerial interest in business firms, branches and subsidiaries located abroad
12. Decreases in the deposits and balances in United States-located banks and other financial institutions owned by foreign residents
- 13 Increases in United States-owned holdings of drafts, bills, checks, accounts receivable, currency and other short-term claims payable by foreign residents.
14. Increases in the United States resident-owned debts, deposits and balances in banks and other financial institutions located abroad.
- 15 Decreases in foreign-owned holdings of drafts, bills, checks, accounts receivable, currency and other short-term claims payable by United States residents
- 16 Loans by the United States government agencies to foreign governments, firms and residents
17. Purchases of foreign-held gold and increases in the United States monetary stock of gold

These rules for debiting and crediting are difficult to follow in the abstract. The next chapter will show how they are applied in actual cases and how balances of payments are drawn up on the basis of specific international transactions.

## QUESTIONS AND PROBLEMS

1. Why do balances of payments record only transactions between residents of different countries?
2. If an American consul at the American Consulate in le Havre, France, bought a house from a French resident of this city, would this transaction find its way into either the United States or the French balance of payments? Why or why not?
3. Under what balance of payments accounts should the following transactions be listed (a) the purchase by American residents of a hotel in London owned by Englishmen, (b) the purchase by an American resident of an airplane ticket from KLM (Dutch) Airlines, (c) the rental for the film *Gone With the Wind* paid by a New Delhi moving picture house, (d) a United States government grant of \$100,000 to Ethiopia for road improvement, (e) the remittance by a Belgian, now residing in San Francisco, of \$1,000 to his family in Brussels, (f) the payment of \$5,000 by a United States importer for a shipment of perfumes from France, (g) the payment of \$5,000,000 by an American automobile manufacturing firm to a West German building contractor for the construction of an automobile plant in West Germany?
4. What is meant by the statement, "The balance of payments forms part of the national or social accounts of a country"?
5. What would you expect to learn from the study of balances of payments?
6. In what ways does a balance of payments resemble and in what ways does it differ from business financial statements?
7. Contrast the claims, assets and liabilities and the payments and receipts approaches to balance of payments debiting and crediting.
8. Classify the following as debits or credits: imports of merchandise; exports of merchandise, United States government loans to Brazil, payments to American missionaries in Kenya by an American church, purchase of common stock in an American corporation by a South African investors' syndicate, payment by a Norwegian of his debt to an American insurance company by means of a draft drawn by a Norwegian bank on its balances in a New York bank, repayment by the Finnish government of its World War I debts to the United States government, payment of hotel bills in Chicago by Swiss tourists.
9. Contrast the balance of payments of the United States for 1960 with the balance of payments of any foreign country for the same year as shown in the *Balance of Payments Yearbook* of the International Monetary Fund.

For bibliography see end of chapter 6

## The Balance of Payments: Some Illustrative Examples

"Now that we have sufficiently proved the Ballance of our Forraign Trade to be the true rule of our Treasure, It resteth that we shew by whom and in what manner the said ballance may be drawn up at all times, when it shall please the State to discover how we prosper or decline in this great and weighty business, whêrein the Officers of his Majesties Customes are the onely Agents to be employed, because they have the accounts of all the wares which are issued out or brought into the Kingdome; and although (it is true) they cannot exactly set down the cost and charges of other mens goods, brought here or beyond the seas, yet nevertheless, if they ground themselves upon the book of Rates, they shall be able to make such an estimate as may well satisfie this enquiry, for it is not expected that such an account can possibly be drawn up to a just ballance, it will suffice onely that the difference be not over great."<sup>1</sup>

One of England's leading Mercantilists, Thomas Mun, by these words indicated some of the difficulties involved in preparing balances of trade. Although governments now have much more data upon which to draw than they did in Mun's day and the science of statistics has made great progress, the preparation of balances of trade or of payments as we now call them, is scarcely any easier than it was in the middle of the seventeenth century when Mun wrote these lines. Given these difficulties, the technique of balance of payments construction cannot easily be mastered by a study of rules of debiting and crediting alone. To obtain a better understanding of it one should practice the art by taking a

<sup>1</sup> Mun, Thomas, *England's Treasure by Forraign Trade or the Ballance of our Forraign Trade is the Rule of our Treasure* (Published by his son, John Mun) London: Thomas Clark, 1664. Quoted from the edition of J. R. McCulloch *Early English Tracts on Commerce*, Cambridge: The University Press, 1954, p. 204.

number of international transactions, making the appropriate debit and credit entries for each and constructing a balance of payments from them.

In this chapter, fifteen examples of typical foreign economic transactions are given. The entries on the United States balance of payments which they require are explained, and a balance of payments statement is prepared from them. Since all statisticians face the problem of obtaining reliable data, homogeneous over time, upon which to base their compilations, the chapter closes with a brief discussion of the more important sources which the United States Department of Commerce utilizes in constructing its tabulations. Reference is made in the cases which follow to the numbers on the left of the page of the "representative debit and credit items" presented at the end of chapter 3.

Transactions in United States and foreign short-term capital may be regarded from several points of view. A transaction which reduces or increases United States short-term assets or liabilities may also increase or reduce foreign short-term assets and liabilities and vice versa. In the following cases, but one of several possible methods of treating each transaction has been selected. United States capital, both long- and short-term, refers to that owned, and generally located abroad, by United States residents, foreign capital is owned by foreign residents and is generally located in the United States. The stage at which a transaction is entered on the balance of payments and the disposition made of the financing instruments may also affect the type of entry used.

*Case I Merchandise Exports* A Swiss importer purchases \$50,000 worth of machine tools from a United States resident manufacturer and arranges to pay by means of a draft drawn on him by the American exporter. The balance of payments entries for these transactions follow:

DEBITS		CREDITS	
Foreign short-term capital	\$50,000	Merchandise exports	\$50,000

The export of merchandise from the United States gives rise to its claim for payment and is a reduction in its assets. It is, therefore, a credit or receipt (Credit item No. 1). When the Swiss importer pays the draft by means of another draft drawn by his Swiss bank on its deposits in New York, it is a debit or payment, since it reduces United States claims and decreases its liabilities to the Swiss (Debit item No. 12).

*Case II Merchandise Imports* An American importer purchases silk textiles from an Italian silk mill and arranges to pay by means of a draft drawn by the Italian exporter on the importer's New York bank's Rome correspondent. The dollar equivalent of the lira value of these textiles amounts to \$50,000.

DEBITS		CREDITS	
Merchandise imports	\$50,000	U. S. short-term capital	\$50,000

The Italian textile mill has a claim against the importer, the transaction increases United States assets and is a debit or payment (Debit item No. 1). When the importer's bank pays the draft the transaction reduces Italy's claims, decreases American assets and is a credit or receipt (Credit item No. 14).

*Case III Travel Imports.* American tourists in France spend \$300,000 in francs for travel, hotel and restaurant bills, entertainment, gifts and other items. These sums are paid to French residents by means of travellers checks drawn on United States financial institutions located abroad.

DEBITS		CREDITS	
Travel	\$300,000	U. S. short-term capital	\$300,000

These purchases constitute French residents' claims on the United States, are increases in American assets and are debits or payments (Debit item No. 2). The travellers checks tendered in payment decrease United States assets abroad, extinguish claims on it and are credits or receipts (Credit item No. 14)

*Case IV Travel Exports* Businessmen from West Germany come to the United States where they spend \$25,000, meeting their expenses with traveller's dollar letters of credit drawn on deposits in U. S.

DEBITS		CREDITS	
Foreign short-term capital	\$25,000	Travel	\$25,000

These expenditures in the United States give rise to claims by it, decrease its assets and are credits or receipts (Credit item No. 2). The U. S. deposits are a form of foreign-owned capital and the dollar drafts drawn on them, when paid, extinguish United States claims, decrease its liabilities to the Germans and are debits or payments (Debit item No. 12).

*Case V Receipt of Income.* American firms receive \$250,000 in drafts drawn by foreign banks on their United States correspondents in payment of interest and dividends on their direct investments in branches and subsidiaries abroad. In addition, they receive \$50,000, remitted in the same way, in payment of interest on their portfolio holdings of foreign securities. The total income received amounts to \$300,000.

DEBITS		CREDITS	
Foreign short-term capital	\$300,000	Income on investments	\$300,000

Interest and dividends payable by foreign residents are claims by the United States, decreases in its assets and are credits or receipts (Credit item No 5) The drafts in payment of these items decrease United States liabilities to foreigners, cancel its claims and are payments or debits (Debit item No. 12).

*Case VI. Payment of Income.* Foreigners receive from American firms interest and dividends amounting to \$50,000 in local currency on their direct and portfolio investment in the United States in drafts on foreign correspondents of United States banks.

DEBITS		CREDITS	
Income on investments	\$50,000	U S short-term capital	\$50,000

These income remittances, payable by the United States to foreign residents, are debits or payments because they increase foreign claims on the United States and decrease its liabilities (Debit item No. 5). The drafts in payment constitute decreases in United States assets, cancel claims by foreigners and are receipts or credits (Credit item No. 14).

*Case VII Private Unilateral Transfers in Cash* Immigrants in the United States send \$25,000 to their families overseas in foreign currency purchased from a New York dealer

DEBITS		CREDITS	
Unilateral transfers	\$25,000	U S. short-term capital	\$25,000

Although an immigrant's cash gift remittance to his family abroad may not be a claim on the United States it has the same economic effect, it is a decrease in its "liabilities" and a debit or payment (Debit item No 8) Foreign currency sent abroad decreases United States assets, reduces foreign residents' claims for payment and constitutes a receipt or credit (Credit item No. 15)

*Case VIII Private Unilateral Transfers in Merchandise.* The same immigrants send gifts of merchandise, valued at \$15,000 to their relatives abroad.

DEBITS		CREDITS	
Unilateral transfers	\$15,000	Merchandise exports	\$15,000

Although the immigrant's shipments are gifts, they are nonetheless merchandise exports and receipts or credits (Credit item No. 1). Since

these exports give rise to no claim for payment, short-term capital accounts are not affected. Instead, the unilateral transfers account is debited (Debit item No. 8).

**Case IX Government Unilateral Transfers** The United States government makes a grant of \$80,000 to Cambodia for road improvement. The grant includes \$40,000 worth of equipment and supplies (merchandise) and \$40,000 in United States contractor's fees (services).

The following steps are taken to implement the transaction: The United States government establishes a credit for \$80,000 in a New York bank's correspondent in Phnom Penh by drawing on this account in favor of the Cambodian government, this credit is drawn upon by the Cambodian government as the equipment and supplies are purchased and as the United States contractor is paid.

DEBITS		CREDITS	
Unilateral transfers	\$80,000	U S short-term capital	\$80,000
U. S short-term capital	\$40,000	Merchandise exports	\$40,000
U S. short term capital	\$40,000	Service exports	\$40,000

The United States grant involves no *quid pro quo* and is a unilateral transfer debit or payment (Debit item No. 8). The credit in favor of Cambodia decreases United States assets held abroad, cancels Cambodia's "claim" for payment and is a credit or receipt (Credit item No. 14). When the supplies and equipment are furnished, a claim on the Cambodian government is created and United States assets are decreased. The transaction is a receipt or credit (Credit item No. 1). When the contractor renders his services there is a reduction in United States intangible assets, he has a claim on the Cambodian government and the transaction is a credit or receipt (Credit item No. 6). The drafts drawn in payment of these items, deposited in Cambodia in favor of United States residents increase the assets and decrease the claims of the United States and are payments or debits (Debit item No. 13).

**Case X Private U S Capital Outflows—Direct Investment** United States resident firms invest foreign currencies amounting to \$75,000 in branches and subsidiaries abroad. Payment is made by foreign currency bank drafts drawn by New York banks on their balances in foreign banks.

DEBITS		CREDITS	
U S long-term private capital-direct investments	\$75,000	U S short-term capital	\$75,000

The investments constitute claims upon American firms, create United States assets, and are payments or debits. These firms have a

managerial interest in the branches and subsidiaries and the debits are to direct investment (Debit item No. 11). The drafts drawn in payment reduce United States assets abroad or foreigners' claims and are receipts or credits (Credit item No. 14).

*Case XI Private Foreign Capital Inflows—Direct Investment.* A French perfume manufacturer decides to manufacture his products in the United States to save transportation costs and customs duties. He arranges with an American contractor to build a perfume plant in New Jersey at a cost of \$75,000 and to pay by a check which he draws on his bank account in New York.

DEBITS		CREDITS	
Foreign short-term capital	\$75,000	Foreign private long-term capital-direct investments	\$75,000

The French perfume maker owns and manages the plant. Since the transaction increases United States claims and decreases its assets it represents a receipt, and direct investments are credited for the amount (Credit item No. 11). The check drawn in payment by the French perfume maker on his New York bank reduces United States liabilities, its claims and constitutes a payment or a debit (Debit item No. 12).

*Case XII Private Foreign Capital Inflows—Portfolio* Swedish businessmen purchase \$50,000 worth of stocks in United States corporations through a broker in New York City and pay for them by purchasing and remitting dollar drafts accepted by American firms. These securities do not give the Swedish businessmen a managerial interest in the corporations and are portfolio investments.

DEBITS		CREDITS	
Foreign short-term capital	\$50,000	Foreign private long-term capital portfolio investments	\$50,000

The purchase of these securities gives the American broker a claim, is a decrease in United States assets and is a receipt or credit (Credit item No. 10). When the Swedish purchasers pay by forwarding the acceptances, these reduce United States claims, decrease its liabilities to Sweden and are payments or debits (Debit item No. 15).

*Case XIII. U S Government Capital Outflows* The Export-Import Bank of Washington lends the government of India \$100,000 to aid in financing a cement factory and draws on its balances in a New Delhi bank in favor of the Indian government.

DEBITS		CREDITS	
U S government long term capital	\$100,000	U. S. short-term capital	\$100,000

When the United States government makes the loan it creates an asset and a claim by India for payment. The transaction is a payment or a debit (Debit item No. 16). When the Indian government's credit with the New Delhi bank is established it reduces India's claim, decreases United States assets held in New Delhi, and is a receipt or credit (Credit item No. 14).

*Case XIV. Private U. S. Capital Outflows—Portfolio Investment.* United States residents purchase stocks and bonds of Japanese firms having a dollar value of \$50,000 and pay for them by their personal checks on Tokyo banks. These securities do not give the purchasers a managerial interest in the firms and are portfolio investments.

DEBITS		CREDITS	
U. S. private long-term capital-portfolio investments	\$50,000	U S short-term capital	\$50,000

The purchase of the securities creates a Japanese claim, represents an increase in United States assets and is a payment or debit (Debit item No. 10). The checks drawn on Tokyo banks decrease United States assets, reduce Japan's claims and are receipts or credits (Credit item No. 14).

*Case XV. Gold Sales and Purchases* The United States Treasury purchases \$150,000 in gold from a mine located in South Africa and pays by a dollar Treasury check. It sells \$100,000 worth of its monetary gold to the Greek government and receives a draft drawn by this government on its New York bank which is deposited in the U. S. account with a Greek bank.

DEBITS		CREDITS	
Gold purchases	\$150,000	Foreign short-term capital	\$150,000
U S short-term capital	\$100,000	Gold sales	\$100,000

Foreign gold sales and purchases are exports and imports of a type of merchandise, but are entered separately on balances of payments because of the special importance of gold in monetary systems and international trade. The purchase of gold increases United States assets, gives rise to a claim for payment by South Africa and is a payment or debit (Debit item No. 17). Payment for the gold purchased by the United States by Treasury check increases its liabilities, reduces claims for

payment on the United States and is a receipt or credit (Credit item No. 13). The sale of gold by the United States reduces its assets, creates a claim on a foreign country and is a credit or receipt (Credit item No. 17). The draft drawn by the Greek government in payment for the gold, when deposited in Greece, increases United States assets, reduces its claims on Greece and is a payment or debit (Debit item No. 14).

### Balance of Payments Based on These Transactions

To prepare a balance of payments in an orderly fashion from transactions I-XV described above, they should first be posted to a worksheet similar to that shown on Table 4.1. From this worksheet, the balance of payments, Table 4.2, is readily derived.

TABLE 4.1  
BALANCE OF PAYMENTS WORKSHEET

Items	Debits (-)	Credits (+)
<i>Current Account—Merchandise</i>		
Imports (Case II)	\$ 50,000	
Exports (Case I)		\$ 50,000
Exports (Case VIII)		15,000
Exports (Case IX)		40,000
Total merchandise	\$ 50,000	\$105,000
Balance on merchandise		\$ 55,000
<i>Current Account—Services</i>		
Travel (Case III)	\$300,000	
Travel (Case IV)		\$ 25,000
Income on investments (Case VI)	50,000	
Income on investments (Case V)		300,000
Miscellaneous services—contractor's fees (Case IX)		40,000
Total services	\$350,000	\$385,000
Balance on services		\$ 15,000
Balance on current account—merchandise and services		\$ 70,000
<i>Unilateral Transfers Account</i>		
Private (Case VII)	\$ 25,000	
Private (Case VIII)	15,000	
Government (Case IX)	80,000	
Total unilateral transfers	\$120,000	
Balance on unilateral transfers	\$120,000	
<i>United States Capital Account</i>		
Government long-term (Case XIII)	\$100,000	
Private long-term		
Direct (Case X)	75,000	
Portfolio (Case XIV)	50,000	
Short term		
Case II		50,000
Case III		300,000
Case VI		50,000
Case VII		25,000

Case IX	\$ 80,000	80,000
Case X		75,000
Case XIII		100,000
Case XIV		50,000
Case XV	100,000	
Total	<u>\$405,000</u>	<u>\$730,000</u>
Balance on U S capital		\$325,000
<i>Summary of U S Capital Account</i>		
Government long term (net)	\$100,000	
Private direct long-term (net)	75,000	
Private portfolio long-term (net)	50,000	
Private short-term (net)		\$550,000
Total	<u>\$225,000</u>	<u>\$550,000</u>
Balance on U S capital		\$325,000
<i>Foreign Capital Account</i>		
Private long-term		
Direct (Case XI)		\$ 75,000
Portfolio (Case XII)		50,000
Private short-term		
Case I	\$ 50,000	
Case IV	25,000	
Case V	300,000	
Case XI	75,000	
Case XII	50,000	
Case XV		\$150,000
Total	<u>\$500,000</u>	<u>\$275,000</u>
Balance on foreign capital	\$225,000	
<i>Summary of Foreign Capital Account</i>		
Private long term direct (net)		\$ 75,000
Private portfolio long-term (net)		50,000
Private short-term (net)	\$350,000	
Total	<u>\$350,000</u>	<u>\$125,000</u>
Balance on foreign capital	\$225,000	
<i>Gold Sales and Purchases Account</i>		
Gold sales (Case XV)		\$100,000
Gold purchases (Case XV)	\$150,000	
Total	<u>\$150,000</u>	<u>\$100,000</u>
Balance on gold sales and purchases	\$50,000	

TABLE 42  
BALANCE OF PAYMENTS

Export of goods and services, total	+	\$470,000
Merchandise	+	105,000
Travel	+	25,000
Income on investments	+	300,000
Miscellaneous Services	+	40,000
Imports of goods and services, total	-	\$400,000
Merchandise	-	50,000
Travel	-	300,000
Income on investments	-	50,000
Balance on goods and services	+	\$ 70,000
Unilateral transfers (net)	-	\$120,000
Private	-	40,000

Government	-	80,000
United States capital movements (net)	+	\$325,000
Government (net)	-	100,000
Private direct (net)	-	75,000
Private portfolio (net)	-	50,000
Short-term (net)	+	550,000
Foreign Capital	-	\$225,000
Private direct (net)	+	75,000
Private portfolio (net)	+	50,000
Private short-term (net)	-	350,000
Gold Sales and Purchases (net)	-	\$ 50,000
Unrecorded transactions-errors and omissions		-0-

### Principal Sources of United States Balance of Payments Data

The balance of payments is no exception to the general rule that a statistical tabulation is no better than the data upon which it is based. The basic data from which the United States balances of payments are derived are obtained from a number of sources of varying reliability, some parts are more accurate than others. On the whole they are reasonably trustworthy estimates, and the magnitudes which they present are homogeneous and comparable over time.

Other countries employ different definitions, sources of data and methods of compilation. Hence, the balances of payments of any two countries are not likely to be strictly comparable in detail. The differences between them, however, are not large, general and over-all comparisons are usually warranted. The longer a nation has been compiling these tabulations, the more accurate they are likely to be because the statisticians preparing them become more expert and the data more reliable.

The principal sources utilized by the United States Department of Commerce statisticians in preparing balances of payments are the following:

*Exports and imports of merchandise.* The monthly and annual tabulations of foreign trade, both exports and imports, prepared by the Bureau of the Census are used for constructing these entries. These data are tabulated from the forms submitted by exporters and importers known as export declarations and import entries. With the exception of transactions having a value of less than \$100, these statistics are tabulations of the universe and are not estimates.

*Transportation.* The basic data for this account are obtained from ocean, airline and other carriers which fill out forms, supplied by the Department of Commerce, providing the requisite information. In addition, certain reports of the Civil Aeronautics Board, the Maritime Commission, the American Association of Railroads and the Interstate

Commerce Commission supply needed figures and are also utilized in constructing this account.

*Travel.* The United States Immigration Service submits reports which include data used to prepare this account. In addition, the Department of Commerce utilizes questionnaires, filled in by travellers on a sample basis, to ascertain certain expenditures of foreign travellers in the United States and American travellers abroad.

*Miscellaneous services* The data for *communications* are obtained directly by the Department of Commerce from firms in the communications business. For *reinsurance* transactions, the Department utilizes figures submitted by all firms believed to be engaged in this activity. *Motion picture rentals* are submitted by American motion picture companies and the earnings in the United States of foreign companies are estimated from income tax returns and withholding statements. *Engineers' and contractors' services* data are derived from questionnaires answered by all firms believed to be engaged in this occupation overseas. *Foreign representational* expenses of foreign governments in the United States are obtained directly by the Department from the countries concerned. Where this information is not available, an estimate of these expenses is made based upon the number and size of the foreign operating missions here. The representational expenses of the United States government abroad are submitted to the Department by the agencies involved in this activity.

*Unilateral transfers* *Individual remittances* or, as they were formally known, *immigrant remittances*, are based upon reports received by the Department of Commerce from agencies known to be in the personal remittance business and from those which sponsor temporary alien workers. The figures for *institutional remittances* are supplied by agencies engaged in relief work as well as institutions carrying on religious, educational, health and welfare work abroad. *Government unilateral transfers* data are gathered by the Department of Commerce directly from those government agencies which engage in overseas operations.

*Capital and income accounts* Censuses of American investments abroad and foreign investments in the United States were taken by the Treasury in 1942 and 1943. In 1950 and 1960 the Department of Commerce took a census of United States direct investments abroad. These tabulations provide benchmark data for the preparation of statistics of capital movements and income receipts and payments. The Federal Reserve System requires elaborate reports from member and other banks, dealers and brokers in foreign exchange and securities underwriters which provide data used to compute long- and short-term capital movements and the receipt or payment of income. In addition, the Department

of Commerce sends questionnaires to American and foreign parent companies, branches and subsidiaries, to obtain data on the movement of direct investments capital and income. Reports are also received from the Securities Exchange Commission and the several state departments of insurance. The Internal Revenue Service tabulations of withholding tax reports supply other data. The movement of government capital is obtained by the *Department from other federal agencies which undertake these operations.*

**Gold Account** The Department uses a variety of sources in elaborating this account. The Bureau of the Census tabulates data periodically showing the imports and exports of gold, earmarking transactions in gold are collected and published by the Federal Reserve Bank of New York while the Treasury publishes tabulations of international gold purchases and sales. In addition the publications of the Federal Reserve Board show changes in the United States gold stock, and those of the Bureau of the Mint present figures on gold production and consumption in the United States.<sup>2</sup>

The balance of payments is a useful statement for the study of international economics because it presents in a few words and figures the broad outlines of the economic relations of a nation with the rest of the world or with selected areas and countries. To obtain the maximum information which these tabulations can be made to yield, they must be analyzed. The next chapter presents one important series of facts which the analysis of these tabulations can provide, the determination of balance of payments surpluses and deficits.

### QUESTIONS AND PROBLEMS

1. Indicate the appropriate debit and credit entries for each of the following transactions:
  - a) An American textile manufacturer imports \$10,000 worth of wool from a New Zealand exporter and pays in British pounds purchased from a New York bank, which drew on its deposits in England.
  - b) An American farm machinery manufacturer sells \$100,000 worth of farm combines to an Argentine importer who pays in dollars bought from an Argentine bank, which drew on its deposits in a New York bank.
  - c) Greek merchants ship goods on United States ships, paying \$10,000 freight for the shipments. Payment for the transactions is made in dollar drafts, drawn by a Greek bank on its deposits in a New York bank.

<sup>2</sup> For a complete account of the sources used in the preparation of the United States balances of payments together with the forms used in gathering the data see: *The Balance of Payments of the United States, 1949-1951*. A Supplement to the *Survey of Current Business*, published by the United States Department of Commerce. Washington: United States Government Printing Office, 1952, pp. 15-117.

- d) American travellers spend \$25,000 in Switzerland paying for their expenditures in dollar travellers checks
  - e) American investors collect dividends and interest, amounting to 49,500 francs, on their investments in France. The payment was made in French francs by means of drafts drawn on a French bank, remitted to the American investors who deposited it to their credit in dollars in American banks. The transactions took place at the rate of exchange, 4 95 new French francs equal one dollar
  - f) Italian immigrants living in the United States remit \$1,000 in cash, and clothing valued at \$2,000, to their families in Italy. The cash remittances were made in the form of dollar drafts drawn on a New York bank.
  - g) An American textile company establishes a mill in Belgium at a cost of 50,000,000 Belgian francs. To pay for the transaction, it purchased Belgian francs from an exchange dealer in New York at a cost of \$1.00 equals 50 Belgian francs and remits these Belgian francs to the contractor in Belgium.
  - h) The United States government makes a grant of \$100,000 to India for the construction of a dam and places the money to the credit of the Indian government in a New York bank. The Indian government purchases \$50,000 worth of equipment to build the dam from American suppliers and pays for it in checks drawn on the same New York bank.
2. Prepare a balance of payments from the transactions listed in question 1.
  3. Given the many sources employed by United States balance of payments statisticians, how would you explain the fact that there are some unrecorded transactions?

For bibliography see end of chapter 6

## The Balance of Payments: Analysis of Surpluses and Deficits

"And Solomon determined to build an house for the name of the Lord, and an house for his kingdom . . . And Solomon sent to Hiram the king of Tyre, saying, As thou didst deal with David my father, thou didst send him cedars to build him an house to dwell therein, even so deal with me. . . . Send me now therefore a man cunning to work in gold, and in silver, and in brass, and in iron, and in purple, and crimson, and blue, and that can skill to grave with the cunning men that are with me in Judah and in Jerusalem, whom David my father did provide. Send me also cedar trees, fir trees, and algum trees, out of Lebanon . . . And, behold, I will give to thy servants, the hewers that cut timber, twenty thousand measures of beaten wheat, and twenty thousand measures of barley, and twenty thousand baths of wine, and twenty thousand baths of oil.<sup>1</sup>

Hiram agreed to this proposal and the transactions were consummated. Assuming they were the only ones undertaken, the following bilateral balance of payments would represent Israel's international economic relations for the period:

Transportation for timber and lumber  
to Joppa

Travel, one worker to Joppa

*Payments*

Exports of merchandise:

Beaten wheat

Barley

Wine

Oil

Not specified

Not specified

Amounts

20,000 measures

20,000 measures

20,000 baths

20,000 baths

Errors and omissions

None

Note: Since these were barter transactions which did not involve any money flows, exports have been classified as payments and imports as receipts, contrary to the usual practice where money is employed. This balance of payments is based upon letters exchanged between the two monarchs rather than upon the actual movement of goods and services exchanged. It is, therefore, an *ex-ante* balance of payments. Since there is no record of the actual amounts of goods and services actually transferred as a result of these arrangements, an *ex-post* balance of payments cannot be computed.

These early transactions illustrate bilateral state trading carried out in a lordly manner and on a barter basis where the parties to the transactions do not even bother to state the values or the amounts involved in all instances. The modern student of balances of payments may well yearn for the days of Solomon and Hiram when trade was simple. But, on the other hand, he should remember foreign trade itself was so simple that balance of payments construction and analysis was nonexistent. In today's world, the balance of payments statistician has a challenging and rewarding job as the following sections and the next chapter suggest.

### Relationships Among Balance of Payments Accounts

A number of people have stated that the recent deficits on the United States balances of payments could be avoided by curtailing imports or that they could be eliminated by abandoning foreign aid programs. The fallacy of these opinions lies in failure to recognize the fact that there are relationships among all of the items and that one of them could not be raised or lowered without lowering or raising some of the others. The balance of payments is an integrated whole, a change in one part must be followed by changes in others.

*Specific relationships among certain accounts* Later chapters draw attention to the fact that there is an important relationship between direct capital investments abroad, on the one hand, and exports of goods and services on the other. Conversely, foreign direct investments in the United States are also related to our imports of goods and services. When foreign concerns solicit American investments they are often motivated by a desire to obtain dollars for the purchase of goods, equipment and supplies here. If imports were not desired, there would be less foreign investment than there is now.

In addition, there is a direct relationship between United States

capital movements and our receipt of income on investment. Barring a decline in the rates of interest and dividends, we could expect larger receipts of income from investments as U. S. capital flows overseas. Conversely, as foreign capital flows into the United States (unless there is a counter-movement in rates of interest and dividends) U. S. payments on income on investment should increase.

Exports and imports of goods are likewise related to transportation, travel and certain miscellaneous services. An export or import must be shipped and consequently the transportation accounts will grow or decline as exports and imports increase or decrease. Since exports and imports of merchandise are usually insured for considerable sums, insurance companies often reinsure a part of the risk with foreign companies. The consummation of business transactions involving the export and import of goods and services and the investment of capital likewise involves considerable international travel on the part of businessmen.

Increasing government unilateral transfers, especially when made for purposes of economic development, may also involve the account "miscellaneous services—government," because the expenditures of our establishments abroad to administer the aid programs are likely to grow as a result. The accumulation of large short-term balances abroad may be followed by investment in foreign long-term portfolio investments so that these funds can earn interest rather than lie idle in bank deposits.

*Role of foreign holdings of U. S. dollars* There has been much misunderstanding of the role of United States dollars earned by our foreign trading partners. Dollar holdings are only good ultimately for two things—spending in the United States or increasing the international or banking reserves of the countries which earn them. Since dollars are legal tender only in the United States they must finally come to rest in the United States if they are spent at all.

If dollars are earned by the United Kingdom, for example, they may be spent in Argentina for imports of beef. The Argentimans might, in turn, spend them in Bolivia to pay for the import of tin, and Bolivia might then buy farm equipment in the United States with these dollars. Unless they are added to a nation's reserves, they will be ultimately spent in the United States and eventually operate toward increasing our balance of payments receipts. If they are used to augment a nation's international or banking reserves, they serve to strengthen the international and domestic position of the recipient country which could become a better trading partner as a result.

Now what proportion of our payments abroad returns to us in the form of receipts from exports and what is retained by foreign countries as a part of their international and banking reserves? A recent study sheds

some light on this question.<sup>2</sup> Our increased imports of goods, under tariff liberalization, mean that other nations will accumulate reserves of dollar exchange and in their turn use a part of them to import more goods from the United States. To calculate the resulting increase in foreign imports from the United States, the study estimates the percentage of dollar exchange earnings of foreign nations which are spent on imports. Table 5.1 shows the estimated percentage of foreign dollar earnings which will be spent on imports from the United States.

TABLE 5.1

UNITED STATES EXPORT INCREASE AS PERCENTAGE OF NET INCREASE  
IN FOREIGN DOLLAR EARNINGS<sup>3</sup>

	Percentage
Minimum	13
First quartile	25
Median	30
Third quartile	53
Maximum	81

The proportion of these reserve earnings of dollars spent on imports varies from a low of 13 per cent to a high of 81 per cent with the median standing at 30 per cent. The figures apply to proportions and prices prevailing in 1953, and reflect a wide variation among the several countries in the amount of dollar earnings devoted to merchandise imports from the United States. In addition, as the study points out, some of the dollar earnings are used to pay for imports from other countries, and a part of these may later return to the United States in payment for purchases made in this country.

The proportion of reserves devoted to imports from the United States also varies over time and to a certain extent is a function of the size of the reserves themselves. Nations with large dollar reserves are inclined to devote larger proportions of them to United States imports than those with smaller reserves.

### Balance of Payments Surpluses and Deficits

Three different concepts of the balance of payments are usually distinguished: the market, the program and the accounting balance. The *market balance* refers to the actual market demand and supply situation for foreign exchange, the *program balance*, to the amounts of foreign exchange demanded and supplied for some specific purposes or pro-

grams; and the *accounting balance*, to the amounts of foreign exchange entered on the debit and credit sides of a balance of payments statement.<sup>4</sup> The market and program balances are termed *ex-ante* concepts because they refer to anticipated changes in balance of payments magnitudes. The accounting balance is called an *ex-post* concept because it refers to changes in balances of payments magnitudes which have already taken place.

This chapter treats only the accounting, *ex-post*, concept of the balance of payments of which there are several types. The two principal ones are those prepared by the United States Department of Commerce and those prepared by the International Monetary Fund. The basic presentations of these two types are frequently rearranged by analysts to develop certain facts of interest or to serve certain specific analytical purposes. In chapter 3 a balance of payments prepared by the Department of Commerce was shown; this chapter utilizes that as well as those constructed by the International Monetary Fund.

*Mercantilist concepts of deficits and surpluses.* The underlying concept of the balance of payments is an old one dating back to Mercantilist thought, probably late in the fourteenth century, when it was then called the balance of trade or the balance of accounts. The Mercantilists were primarily interested in specie flows in and out of a country resulting from transactions on the merchandise and services accounts. It was later recognized that surpluses and deficits on the current account could be liquidated by capital flows, as well as by specie, and capital was believed to be a balancing medium for current account surpluses and deficits.

Methods of financing the current account so heavily emphasized by the Mercantilists are still studied for certain analytical purposes. In 1949, for example, the Economic Cooperation Administration and the Department of Commerce sent a joint mission—the Taylor Mission—to Europe to investigate Europe's dollar deficit and to explore the possibility of increasing its dollar earnings. As one of the supporting documents of the *Report* which this Mission issued, a statement of the methods of financing the United States current account surplus was appended and is reproduced in Tables 5.2 and 5.3.<sup>5</sup>

These tables show the extent to which surpluses were financed between 1914 and 1948 by the liquidation of foreign-held gold and dollar

<sup>4</sup> Cf. Machlup, Fritz "Three Concepts of the Balance of Payments and the So-Called Dollar Shortage" *Economic Journal* (March, 1950), 46-68 and Badger, Donald C. "The Balance of Payments: A Tool of Economic Analysis" *Staff Papers, International Monetary Fund* (September, 1951), 149-162.

<sup>5</sup> *Report of the ECA-Commerce Mission: The Economic Cooperation Administration*, Washington, D.C. U.S. Government Printing Office, October, 1949, p. 42.

TABLE 53  
MEANS OF FINANCING THE U S EXPORT TRADE BALANCE BY PERIODS,  
1914 TO 1948 — PERCENTAGES

ITEM	7/1/14- 12/31/ 1918	1919- 1922	1923 1929	1930- 1940	1941- 1945	1940- 1948	Total 7/1/ 1914-48
Exports	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Means of Financing Excess of Exports							
Liquidation of gold and dollar assets	29.98	10.98	-39.57	102.77 <sup>1</sup>	-13.71	28.89	15.42
Dollar disbursements (net) by							
International Monetary Fund	-	-	-	-	-	2.00	0.05
International Bank	-	-	-	-	-	1.91	0.48
United States Gov't aid							
Grants (net)	-2.90	2.98	1.22	2.45	101.05	31.05	48.45
Long- and short-term loans (net)	71.30	21.24	-4.05	-1.07	5.14	27.95	18.61
Subsidies (net)	8.60	19.39	32.04	29.13	3.60	0.90	10.58
Long- and short-term private capital (net)	14.11	18.55	91.04	-36.22	1.25	7.63	10.23
Errors and omissions	-19.09	26.88	19.32	-57.19	-1.23	-8.99	-4.43
a footnote	-	-	-	9.13	-	-	0.01

The net long term capital transaction figure for 1933 includes \$40,000,000 and that for 1934 includes -\$30,000,000 representing the net transfer of funds in security arbitrage operations. These transactions cannot be divided between domestic and foreign securities in these years.  
Source: Department of Commerce.

assets, by private capital and by United States government loans and grants. During this period as a whole, a surplus of over \$100 billion was thus financed; about 48 per cent of it was met by United States government grants and 16 per cent by government loans. Note that these figures include in the grants about \$44 billion worth of Lend-Lease.

*Deficits and surpluses on the balance of payments as a whole.* Under the Classical School, which came to occupy a dominant position in economics after the Mercantilists, attention was directed to such economic theories as the doctrine of comparative advantage, the price-specie-flow mechanism and the international level of prices. The Classical authors were little interested in the construction and analysis of balances of payments and but limited progress was made in this art during the ascendancy of this School. Beginning in the nineteen-twenties, interest in balance of payments underwent a renaissance and this concept is now assuming an increasingly important place in both the science and art of international economics.

To be significant and effective, economic analysis should emphasize matters of current interest and importance. Our international financing problems today are not those involved in the current account alone but include the means of payment of all the items on the balance of payments.

This problem is one of determining the funds available for making international payments and is of importance since international and banking reserves are required to sustain a nation's external and domestic monetary economies. Liquidity and growth depend, in part, upon them. When a nation lacks the means of external payment it finds difficulty in importing and investing abroad. To earn international reserves, such a nation must concentrate upon exports and other receipts, and this may require a program of austerity as it did for the United Kingdom during the immediate post-World War II years. In addition, reserve-short nations often restrict imports and capital outflows through the use of import and exchange controls which tend to reduce the level of world trade.

The analysis of surpluses and deficits on the balance of payments as a whole involves a definition of the movement of international reserves as well as techniques for calculating this movement. Where a nation is experiencing a surplus, its international reserves increase, where it has a deficit, they decline. It is easy to state this concept, but its calculation involves points of both theory and technology and is seldom a simple process. One is obliged to distinguish between independent and balancing capital movements, this procedure usually involves an element of judg-

ment and is not always entirely objective.<sup>6</sup> The surplus and deficit analyst, since he is confronted by the fact rather than the reasons for it, is obliged to proceed by trial and error or to employ *ad hoc* methods of empirical analysis. Among the several possible definitions and methods of segregating surpluses and deficits two are of special importance: that employed by the United States analysts and that formerly used by the International Monetary Fund.

*Deficit and surplus determination—U. S. procedures.* The hypotheses which underlie the United States deficit and surplus determination are that where foreign nations accumulate liquid holdings of U. S. dollars and gold, the balance of payments is in deficit by the amount of these items. Where these foreign holdings decline, the balance is in surplus by the amount of the decline. Where there is no change in these balances, there is neither deficit nor surplus and the accounts are in balance.

Liquid dollar holdings or balances may be defined as short-term assets, or those having a maturity of one year or less, plus long-term United States government securities. Returning to the United States balances of payments for 1959 and 1960, presented on Table 31, the liquid dollar balances and government securities held by foreigners are shown on lines 45, 46 and 47 and the gold sales and purchases on line 48. For 1960, using the figures on this table, the deficit amounted to \$3.8 billion and is given on line 49. It is computed as follows:

TABLE 54  
COMPUTATION OF THE DEFICIT ON THE UNITED STATES  
BALANCE OF PAYMENTS FOR 1960  
(Millions of dollars)

Liquid dollar holdings (Lines 45-47)	
Line 45, Foreign purchases of U. S. government bonds and notes	127
Line 46, Increase in U. S. short-term liabilities to foreign banks	2,107
Line 47, Increase in other U. S. short-term liabilities	- 104
Total liquid dollar holdings	2,130
Gold and convertible currencies held by U. S. monetary authorities (Line 48)	1,702
Total liquid dollar holdings and gold (Line 49)	3,832

The definition of United States surpluses and deficits presented above is the one generally employed, but it is not the only possible one.

<sup>6</sup> Independent and balancing capital movements are sometimes termed *autonomous* and *induced*. They are held to be autonomous when they occur as a result of independent market forces or the judgment of investors and induced when they are made, either by government authority or market forces, to bring a nation's receipts and payments into balance. The terms autonomous and induced are also applied to international transactions under the Keynesian multiplier analysis to indicate those which occur as a result of income changes—induced—and those which occur independently—autonomous. To avoid confusion, the terms independent, and balancing or dependent, capital movements are used in this work to apply to capital movements which occur independently or to bring the accounts into balance, and autonomous and induced in conjunction with the study of the income or multiplier effect.

According to another definition, private short-term capital movements (line 37) are excluded. In 1960, this item amounted to \$1.3 billion and, if this definition is used and these outflows subtracted, the deficit becomes \$2.5 billion ( $\$3.8 - \$1.3 = \$2.5$  billion). Some analysts regard the item, errors and omissions, line 50, \$0.6 billion, as representing the unrecorded outflow of short-term capital and feel that it should be taken into account in computing surpluses and deficits. If this definition is adopted, the deficit becomes \$1.9 billion ( $\$2.5 - \$0.6 = \$1.9$  billion). Other definitions are possible, and in analytical work of this type it is important that the definition fit the purpose for which it is made.

The term liquid dollar assets lacks precision, because liquidity is a relative term. In United States analytical work, only short-term assets and government securities are held to be liquid. However, with the well-organized security markets, many long-term stocks and other bonds, at least those listed on an exchange, are liquid in that they may be converted into cash on short notice. Given the fluctuations in the prices of these securities, they may only be liquid at a price—the going price on the exchange on which they are quoted. For some analytical purposes, notably under the procedures formerly used by the International Monetary Fund, some of them have been regarded as liquid holdings. It should be noted that it is not the general practice in the United States to regard these securities as a part of a nation's liquid assets.

Table 5.5 presents United States deficits for 1957 and 1958 and also illustrates another form which balance of payments presentations may take. This form may be termed the foreign exchange budget type because its principal emphasis is on the growth and decline of foreign exchange reserves.

The statement for 1958 reveals a deficit on U. S. accounts of \$3.4 billion. Of the total amount of dollar exchange earned in the year, foreign governments converted \$2.3 billion into gold, a fact which disturbed many Americans. The deficit occurred in spite of a surplus of \$2.2 billion on the current accounts. In 1958, United States investment abroad increased by \$3.8 billion and so the balance of payments for this year shows that this country was an *investing* nation. The statement also indicates that unilateral transfers amounting to \$2.3 billion were made in 1958, therefore, it was also in that year a *donating* nation. Investment plus unilateral transfers and military expenditures account for the fact that the balance of payments was in deficit in 1958.

The statement for 1957 presents a different picture. During this year the balance of payments was within \$400 million of being in equilibrium, just about as close as it ever comes to being in balance. There was a surplus on the current account—a saving—of \$5.6 billion, but heavy

TABLE 55

BALANCE OF PAYMENTS OF THE UNITED STATES  
WITH FOREIGN COUNTRIES AND INTERNATIONAL INSTITUTIONS\*  
*In billions of dollars. receipts, payments (-)*

Type of Transaction	Calendar Years	
	1957	1958
<i>Goods and services</i>		
Exports of merchandise	19.4	16.2
Imports of merchandise	-13.3	-12.9
Trade balance	6.1	3.3
Investment income, net	2.2	2.2
Transportation, travel, and miscellaneous services, net	0.7	0.1
Balance on goods and services before United States military expenditure abroad	9.0	5.7
United States military expenditure abroad	-3.2	-3.4
Over-all balance on goods and services	5.8	2.2
<i>Grants and capital, net</i>		
Private remittances	-0.5	-0.5
Government grants	-1.8	-1.8
Subtotal	-2.3	-2.3
United States capital		
Private	-3.2	-2.8
Government	-1.0	-1.0
Subtotal	-4.1	-3.8
Long-term foreign capital	0.4	—
Balance on grants and capital	-6.0	-6.1
<i>Errors and omissions or unrecorded transactions</i>	0.7	0.4
Over-all payments balance	0.4	-3.4
<i>Settlement items</i>		
United States sales of gold	-0.8	2.3
Increase in foreign liquid dollar holdings	0.4	1.2
Total	-0.4	3.4

\* Military aid grants and associated exports of goods and services are excluded throughout. Components may not add to totals because of rounding.

Source: *Monthly Review*, Federal Reserve Bank of N. Y., November, 1959.

investments, \$4.1 billion and grants and private remittances of \$2.3 billion more than counterbalanced the current account surplus. In 1957 foreigners increased their long-term investments in the United States by \$400 million. Without this receipt of funds the deficit would have been even greater.

**Deficit and surplus determination—IMF procedures** The experience of the International Monetary Fund with the determination of balance of payments surpluses and deficits affords a good illustration of the difficulties involved in such computations. The problems which confront the Fund are somewhat different from those in the United States. Since one of the several objectives of the Fund is to assist member nations in their balance of payments difficulties, it is natural that the Fund would con-

centrate on members' holdings of foreign exchange. The International Monetary Fund at first measured the deficits and surpluses of its members by computing the financing needed to balance their accounts and by calculating the growth or decline in their holdings of foreign exchange and certain types of other capital for each period. This method differs from that employed by the United States, where the surpluses and deficits are determined by computing the amount of gold and dollar exchange which other nations earned rather than those which the United States, itself, earned.

The International Monetary Fund proposed the concept of "compensatory official financing" as its early approach to this problem. According to this concept governments exercise considerable control over the movement of gold and foreign exchange and endeavor by both direct and indirect action to bring or maintain these reserves up to desired levels. Governments engage in considerable short-term financing through the purchase and sale of foreign exchange, they also regulate the movement of foreign exchange through import and exchange controls and the foreign exchange transactions of their commercial banks. The sum of the official and private banking exchange transactions are held to measure the surplus or deficit on the balance of payments. The hypothesis underlying this concept is that the increase or decrease in official and banking foreign exchange and gold reserves measures the magnitude of the surplus or the deficit on the balance of payments.<sup>1</sup>

Item F Compensatory Official Financing, net, of Table 5 6, shows this concept as worked out by the Fund's staff for Latin America for 1947. Latin America ran a deficit in 1947 with the rest of the world on recorded transactions, as shown by Item D amounting to -\$209 million. The errors and omissions, or unrecorded transactions, totalled -\$214 million. The sum of these two items, -\$423 million, the total amount of Latin America's balance of payments deficit, was officially financed by the items listed under F. It should be noted that this official compensatory financing does not include "special official financing," Item C, or financing designed to cover certain special purposes and of a generally nonrecurrent character.

With the improvement in the world's banking and international reserves which became manifest in 1953, the concept of official compensatory financing lost some of its significance. The quantitative deter-

<sup>1</sup> See the *Balance of Payments Yearbook 1938, 1946, 1947* International Monetary Fund, Washington, D C 1949, p 5. The concept of official compensatory financing presents many complexities. For a fuller discussion of this concept the reader is referred to this *Yearbook*, pp 4-24, to the *Balance of Payments Manual* of the International Monetary Fund, January, 1950, pp 108-11, and to Badger, Donald C., "The Balance of Payments: A Tool of Economic Analysis," *Staff Papers*, International Monetary Fund, September, 1951, pp 86-197.

TABLE 56

FINANCING OF TRANSACTIONS OF LATIN AMERICA WITH REST OF WORLD, 1947<sup>1</sup>  
(In millions of U. S. dollars)

	TOTAL
A. Goods and Services and Private Donations	
Trade balance (f o b.)	472
Nonmonetary gold, net	50
Investment income, net	-580
Transportation and insurance, net	-516
Foreign travel, net	27
Other services, net	-65
Private donations, net	-7
Total	-619
B. Private Capital, net	
Direct investment liabilities	280
Other long-term capital	-18
Short-term capital, net <sup>2</sup>	174
Total	436
C. Special Official Financing, net	
Donations	24
Loans received <sup>3</sup>	110
Amortization and other repayments <sup>4</sup>	-93
IMF, IBRD gold and dollar subscriptions	-67
Total	-26
D. Surplus or Deficit (-) of Above Items	-209
E. Errors and Omissions, and Multilateral Settlements	-214
F. Compensatory Official Financing, net	
Repurchase of foreign debt and debt settlements	-177
Loans received or extended (-)	-199
IMF advances	31
U. S. Stabilization Fund loans	100
Other foreign exchange liabilities <sup>5</sup>	69
Foreign exchange holdings <sup>2</sup>	-279
Monetary gold holdings	878
Total	423

<sup>1</sup> No sign indicates credit, minus sign indicates debit

<sup>2</sup> Changes in public holdings of U. S. notes and coin in Cuba, \$28 million increase (debit), and the Dominican Republic, \$5 million decrease (credit), are shown under foreign exchange holdings in compensatory financing rather than in private short-term capital movements

<sup>3</sup> From U. S. Government, mostly Export-Import Bank loans, includes an \$11 million U. S. short-term advance to Cuba

<sup>4</sup> Includes \$13 million repayment by Mexico of U. S. short-term credit. Excludes \$12 million repurchase of public debt by Dominican Republic, which is entered in compensatory debt repurchases

<sup>5</sup> Excludes U. S. short-term advance to Cuba, \$11 million, and Mexican repayment of U. S. short-term credit, \$13 million, see footnotes 3 and 4.

Source: *Balance of Payments Yearbook*, 1938, 1946, 1947. International Monetary Fund, Washington, 1949, p. 60

mination of this financing also involved judgments concerning what was and what was not official compensatory financing and its magnitude was, therefore, not entirely objective. In addition, this concept was not sufficiently flexible to meet the requirements of all the members of the Fund, many of which had special problems involving solutions poorly adapted to its confines. In 1954, therefore, the Fund abandoned its use. In its place a close approximation of surpluses and deficits has been substituted, sufficiently exact for most analytical purposes and prepared individually for each country to suit the exigencies of each case.

In making its analyses, the Fund obtains from each country a table of basic data prepared in accordance with its *Balance of Payments Manual* and other instructions. Table 5.7 shows the basic data for India for 1959-1960. From basic tables such as these, the Fund's staff (in collaboration with balance of payments technicians of the country concerned) prepares analytical balances of payments. Table 5.8 presents the analytical balance of payments for India for 1958-1959.

Group D on the analytical balance of payments, Table 5.8, presents an approximation of the deficits and surpluses on India's balances of payments. In 1958 the deficit amounted to 4,329 million rupees. This deficit was financed, or compensated, by official loans and grants received totaling 3,064 million rupees (group E), and monetary movements (group F) 1,265 million rupees. In spite of the very large loans and grants which India received, its reserves of foreign exchange declined by 1,265 million rupees in that year as shown in group F.

The loans and grants received from the United States, shown in group E, were substantial and it is interesting to note that India also received help from Canada, the Federal Republic of Germany, the International Bank for Reconstruction and Development, Britain and the U.S.S.R. In view of the decline in India's holdings of foreign exchange, India may be said to have *dishoarded* in that year. There was a net inflow of private donations, long- and short-term capital as shown under group B, but from the data presented we are not able to tell if the investment inflow represented India's disinvestments abroad or foreigners' investments in India.

A somewhat different picture is presented by the analytical balance of payments for 1959, Table 5.8. The deficit on the current accounts (group A) -2,463 million rupees, the surplus on miscellaneous donations and capital (group B) of +416 million rupees, and errors and omissions (group C) -352 million rupees, left India's balance of payments in a net deficit of -2,399 million rupees. But in this year India received 3,074 million rupees worth of official loans and grants (group E), which more than counterbalanced this deficit and gave India net accruals on the

TABLE 5.7

## INDIA

Basic Global Data, 1959 and 1960

(In millions of Indian rupees)

	1959		Provisional 1960		
	Credit	Debit	Credit	Debit	
A. Goods and Services	7,747	10,274	7,955	11,890	
1. Merchandise	6,279	9,377	6,273	10,577	
2. Nonmonetary gold	59	—	—	—	
3. Freight and insurance	} 284	} —	} 1,682	} 1,313	
4. Other transportation					
5. Travel	191	92			
6. Investment income	134	399			
Direct investment income	—	—	} 1,682	} 1,313	
Other	—	—			
7. Government, n.i.e.	535	132			
8. Other services	265	274			
Net goods and services	—	2,527	—	3,935	
B. Transfer payments	971	164	879	164	
9. Private	582	164	469	164	
10. Central government	389	—	410	—	
Net transfer payments	807	—	715	—	
Net total (1 through 9)	—	2,109	—	3,630	
Net total (1 through 10)	—	1,720	—	3,220	
C. Capital and Monetary Gold	2,041	—	3,325	—	
Nonmonetary sectors	2,604	—	2,911	—	
11. 12. Direct investment and other private long-term	} —	82	} —	25	
Direct investment liabilities		} 97		} 44	
Other liabilities					
Assets	15	—	19	—	
13. Other private short-term	—	26	—	10	
14. Local government	—	—	—	—	
15. Central government	2,712	—	2,946	—	
Long-term liabilities	1,939	95	} 3,024	} —	
Short-term liabilities	728	—			
Assets	140	—			
Monetary sectors	—	563	414	—	
16. Private institutions, liabilities	38	—	70	—	
17. Private institutions, assets	40	—	2	—	
18. Central institutions, liabilities	739	—	—	329	
To IMF	737	—	—	329	
Other	2	—	—	—	
19. Central institutions, assets	—	1,380	671	—	
IMF subscription	—	952	—	—	
Other foreign assets	—	428	671	—	
Monetary gold	—	—	—	—	
Net Errors and Omissions	—	321	—	105	

Source: *Balance of Payments Yearbook*, IMF, Vol. 13, 1960.

TABLE 5.8

## INDIA

## INTERNATIONAL TRANSACTIONS 1958-1959

(In millions of rupees)

	1958	1959
A. Goods and Services		
Exports f.o.b.	5,643	6,276
Imports c.i.f.	-10,568	-9,375
Private	-5,286	-4,924
Government	-5,282	-4,451
Trade balance	-4,925	-3,099
Transportation and insurance	319	277
Investment income	-152	-190
Government, n.i.e.	189	458
Other	125	93
Total	-4,444	-2,483
B. Miscellaneous Donations and Capital		
Private donations	422	386
Private long term capital	-206	-29
Private short-term capital	-19	-27
Official repayments	178	58
Miscellaneous official and bank capital	-45	28
Total	330	418
C. Net Errors and Omissions	-215	-352
D. Total (A through C)	-4,329	-2,399
E. Official Loans and Grants Received		
MSA/FOA/ICA grants	146	179
Colombo Plan grants	185	180
Other grants	1	1
Canadian Government loan	155	1
Federal Republic of Germany loans	342	325
IBRD loans	732	456
Japanese loan	-	25
U.K. loans	224	504
U.S. loans	902	1,277
U.S.S.R. loans	377	126
Total	3,064	3,074
F. Monetary Movements		
Net IMF position	21	-216
Payments agreements (net)	-	-48
Other short-term liabilities to foreign official and banks	49	-44
Other foreign assets (increase-)	1,195	-367
Total	1,265	-675

Source: *Balance of Payments Yearbook*, IMF, Vol. 12, 1960

monetary movements of foreign exchange (group F) of 675 million rupees. So in this year, India *hoarded* foreign exchange.

India's balances of payments in both years were *unsustainable*. However, India is in the process of a far-reaching program of long-term economic development. As economic development proceeds apace the Indian planners expect that its exports will increase, its need for extraordinary imports decline, the heavy deficit on the current accounts will require but little special or compensating financing and its balance of payments will become *sustainable*.

The term "fundamental disequilibrium" was employed, but not defined, in Article IV, Section 5, Paragraph a of the Articles of Agreement of the International Monetary Fund which states: "A member shall not propose a change in the par value of its currency except to correct a fundamental disequilibrium." A balance of payments does not provide sufficient information in itself to determine whether or not a nation is in fundamental disequilibrium. Such a determination must take into account the entire level of economic activity of a country and involves the study of its employment, output, price levels and income, among other things. So, although India's balance of payments displayed deficit characteristics in the two years studied above, the balances of payments by themselves do not tell us whether this reflected a fundamental disequilibrium or not.

Analyses of the surpluses and deficits on the balances of payments, although they have received the most attention, are not the only studies to which these compilations lend themselves. The following chapter discusses other inferences which may be drawn, upon analysis, from these tabulations.

## QUESTIONS AND PROBLEMS

- 1 Why did the International Monetary Fund arrange to publish the balances of payments of its member nations?
- 2 Cite reasons for the decline in interest in surpluses and deficits on the current account and the increasing interest in surpluses and deficits on the balance of payments as a whole.
- 3 In Chapter 5, some of the relationships among the several items on a single nation's balance of payments were described. What relationships exist between the balances of payments of any two nations trading with each other?
- 4 Explain the differences in the methods of computation of balance of payments surpluses and deficits employed in the United States and those formerly used by the International Monetary Fund under its concept of official compensatory financing.
- 5 Why did the International Monetary Fund abandon its concept of compensatory official financing?

6. To what uses do foreign nations put their earnings of dollars?
7. What is meant by *ex-post* and *ex-ante* statements of a nation's international economic relationships?
8. How was the United States surplus on its current account financed between 1914 and 1948?
9. What inferences do you draw from India's balances of payments for 1958 and 1959?
10. Using the figures presented on Table 3 1, compute the deficit on the United States balance of payments for 1959

For bibliography see end of chapter 6

## The Balance of Payments: Analysis of Characteristics and Trends

"There are yet some petty things which seem to have reference to this Ballance, of which the said Officers of his Majesties Customs can take no notice, to bring them into this accompt. As namely, the expences of travaillers, the gifts to Ambassadors and Strangers, the fraud of some rich goods not entred into the Custom-house, the gain which is made here by Strangers by change and re-change, Interest of mony, ensurance upon English mens goods and their lives: which can be little when the charges of their living here is deducted; besides that the very like advantages are as amply ministred unto the English in forraign Countreys, which doth counterpoize all these things, and therefore they are not considerable in the drawing up of the said Ballance."<sup>1</sup>

Such were some of the contributions of Thomas Mun, one of the leading British Mercantilists, to the art of balance of payments construction and interpretation. Until recent years, attention continued to be focused upon surpluses and deficits as it was in Mun's day, but in the last decade balance of payments analysts have sought to draw other and broader inferences from these tabulations.

### Special Problems of Balance of Payments Analysis

*Foreign economy largely dominated by a single industry.* Since more than 90 per cent of Venezuela's exports consist of oil extracted by foreign-owned companies, an analytical balance of payments was constructed by the International Monetary Fund for this country to show some of the effects of this fact. Group A of the items in Table 6.1 presents the

<sup>1</sup> Mun, Thomas. *England's Treasure by Forraign Trade or The Ballance of our Forraign Trade is the Rule of our Treasure* (Published by his son, John Mun.) London: Thomas Clark, 1664. Quoted from the edition by McCulloch, J. R., *Early English Tracts on Commerce* Cambridge: The University Press, 1954, p. 207.

transactions of the oil companies separately from those of the other sectors of Venezuela's economy. The credit items in this group indicate the foreign exchange receipts of these firms and the debits their foreign exchange expenditures, including the accumulation of balances abroad. Although the entries also comprise some offsetting items which do not represent foreign exchange transactions such as reinvested earnings and capital movements, the total of the transactions recorded in Group A, adjusted for errors and omissions, gives an approximate indication of the foreign exchange earned by Venezuela as a result of the operations of its oil companies and is a rough measure of the net first impact of these transactions on the domestic flow of income.

In 1952 the oil sector earned almost \$800 million in foreign exchange for Venezuela. On the other sectors of the economy, the current accounts showed a deficit amounting to about \$684 million, leaving a net surplus of about \$116 million. Group F shows that the total balance of payments deficit for the non-oil sector amounted to \$730 million in 1952. The differences between Group A, total receipts earned as a result of the oil company operations (\$794.4 million), and Group F, net expenditures (-\$730.0 million) are reflected in the changes in Venezuela's international reserves as shown in Group G (\$69.4 million).

Source. *Balance of Payments Yearbook*. International Monetary Fund. Vol. 5, 1954

*Foreign economy dominated by a single crop.* The analytical balances of payments for Brazil, 1947-1953, presented on Table 6.2, are indicative of the foreign transactions of a country largely dependent upon the exports of a single crop for which price changes had an important impact on the external economy. In Group A on this statement, coffee exports have been separated from Brazil's other exports.

The value of coffee exports increased substantially over the period while that of other exports declined. This increase was due primarily to the increase in the prices of this crop. To separate the influences of the changes in volume from those in price, the value of coffee exports has been divided into two parts by the analysts of the Fund: Exports at a constant (1947) price and the excess of current values over their values in 1947 prices. The entries under coffee at 1947 prices reflect changes in the volume of exports only, while those on the next line on the statement reflect the price differential multiplied by the volume of exports.

During World War II, Brazil earned substantial amounts of foreign exchange through her exports to the Allied belligerents, and beginning in 1947 it used some of this exchange to liquidate certain public debts. These extraordinary transactions are shown in Group E. After World War II, Brazilian payments for imports were from time to time delayed, a fact which disconcerted American exporters to that country. A special category on the balance of payments, Group H, was established by the Fund staff to aid in the analysis of this situation. Brazil obtained a substantial loan from the Export-Import Bank which was used in 1953 to assist in meeting payments due to American exporters. The account "deferred payments" in this group represents a species of forced loan obtained by Brazil from United States exporters through the operation of the official

exchange controls which prevented the prompt payment of imports. The Brazilian authorities recognized the nature and effects of this forced loan and made arrangements for its payment.

The Group I accounts represent a more widely-employed type of financing. The items in this group reflect, however, the monetary movements arising from the extraordinary debt settlement shown in Group E and should not be regarded as a measure of the deficits or surpluses on Brazil's balances of payments. The combined totals of Groups H and I provide a better picture of the over-all position, but no combination of groups can properly be used to summarize Brazil's surpluses and deficits. The total of Group C affords some indication of the balance due to the more normal, or structural, factors while that of Group D approximates the over-all deficit or surplus in Brazil's balance of payments as a whole.

### Features of Post-World War II U. S. Balance of Payments

Tables which showed how the surpluses and deficits on balances of payments as a whole could be determined were presented in chapter 5. In this section, the simple statistical techniques of percentage distribution and index numbers will be applied to the United States post-World War II statements to indicate recent changes in the pattern, and shifts in the trends, of U. S. international economic relations.

*Patterns of receipts and payments* In balance of payments analysis, two basic divisions are generally used. Receipts are separated from payments, and a distinction is thus made between the external sources of funds earned and the uses to which these outside funds are put. As Table 6.3 shows, in spite of certain year to year variations, the proportion of funds derived from the export of goods and services and those from foreign capital inflows has not changed greatly. The same stability is not evidenced, however, in the payments, or the uses to which these receipts were put, as Table 6.4 indicates.

By far the largest source of United States international receipts, since World War II, has been the export of merchandise and services. In but one year, 1950, did earnings from this source fall below 90 per cent of total receipts. The United States has been spending a smaller proportion of its total payments on imports of goods and services, in no year did they exceed 78 per cent of total payments. Capital outflows have utilized substantial fractions of foreign exchange earnings. During the years 1946-1948, U. S. overseas investments were important in the scheme of payments, from 1949 to 1956 their importance diminished, but since 1956 they have been again increasing.

*Payments as percentages of receipts on current accounts* How do United States exports of goods and services compare with imports? One

TABLE 6.2  
BRAZIL  
INTERNATIONAL TRANSACTIONS, 1947-53<sup>1</sup>  
(In millions of cruzeiros)

	1947	1948	1949	1950	1951	1952	1953 <sup>2</sup>
Goods and Services							
Exports, f.o.b.							
Coffee, at 1947 prices	7,810	9,211	10,200	7,612	6,614	6,331	6,195
Excess of current coffee value over value at 1947 prices	-	-142	1,488	6,208	10,986	10,975	13,645
Other exports at current prices	13,590	12,615	6,656	9,117	13,162 <sup>3</sup>	6,891 <sup>3</sup>	8,649 <sup>3</sup>
Total exports	21,400	21,334	20,344	25,137	32,762	26,197	28,489
Imports, f.o.b.	-16,990	-16,733	-17,514	-17,278 <sup>3</sup>	-31,498	-31,480	-20,652
Trade balance	2,410	5,151	2,830	7,659	1,264	-5,283	7,837
Foreign travel	-593	-94	-23	-52	-284	-89	-472
Freight on imports	-3,240	-3,380	-2,370	-2,330	-4,281	-4,216	-2,494
Other transportation	472	494	476	105	-286	140	86
Investment income	-1,013	-1,943	-1,881	-2,027	-2,898	-2,240	-2,333
Other services	-720	-916	-1,208	-1,563	-2,185	-1,430	-1,339
TOTAL	-2,884	-690	-2,179	1,992	-8,648	-13,098	1,257
Private Donations and Capital (excluding deferred payments, Group H)							
Remittances	-329	-142	-64	-60	-61	-72	-304
Direct investment	1,013	1,249	623	724	1,174	1,749	402
Other long-term capital	-239	-133	-3	-176	-118	-	404
Short term capital	93	366	-213	-28	245	442	150
TOTAL	538	1,340	543	460	1,240	2,119	652
2. Total (A plus B)	-2,146	650	-1,636	2,452	-7,408	-10,979	1,939
3. Miscellaneous Official Donations and Long-Term Capital							
Grants	-107	15	11	15	16	32	51
Official loans received	594	179	742	513	700	642	722 <sup>4</sup>
Gold subscription to IMF	-	-693	-	-	-	-	-

	1947	1948	1949	1950	1951	1952	1953 <sup>2</sup>
Amortization and lend-lease settlement	-519	-754	-530	-1,571	-405	-633	-723
Credits to Finland and Paraguay and other	-185	-	-	-	3	38	37
TOTAL	-217	-1,253	-223	-1,043	-224	-79	-87
Debt Settlements	-	-714	-	-60	-540	-	-
Purchase of British investments	-	-331	-157	-	-	-	-
Extraordinary repayment of public debt	-	-	-	-	-	-	-
Sterling	-357	-	-	-	-	-	-
French francs	-25	-	-185	-	-	-	-
U. S. dollars	-382	-1,045	-342	-60	-540	-	-
TOTAL	-2,745	-1,048	-1,755	1,349	-7,724	-10,900	2,026
Total (C through E)	-1,077	255	2,042	-298	2,259	-912	404
Net Errors and Omissions	1,516	630	515	-1,917	552	10,435	-7,496
Import Credits	-	-	-	-	-	-	5,550
Deferred payments (net)	-	-	-	-	-	-	-1,946
Export-Import Bank loan	-	-	-	-	-	-	-
TOTAL	1,516	630	515	-1,917	552	10,435	-7,496
Monetary Movements	1,480	-370	-1,119	-	-	-	-
U. S. Stabilization Fund loan (net)	-	-	694	-	518	-518	518
Use of IMF resources (net)	-30	824	715	678	4,413	1,912	-987
Sterling balances, net (increase-)	856 <sup>3</sup>	-384	-1,092	205	-	-	-
Other short term assets, net (increase-)	-	693	-9	-17	-18	-17	-15
Monetary gold (increase-)	-	-	-	-	-	-	-
TOTAL	2,308	763	-802	866	4,913	1,377	-484

<sup>1</sup> No sign indicates credit, minus sign indicates debit.

<sup>2</sup> Preliminary.

<sup>3</sup> Including nonmonetary gold.

<sup>4</sup> Excluding Export-Import Bank loan included in Group H.

<sup>5</sup> Including a decrease in holdings of portfolio securities (\$ million crozetos).

Source. Balance of Payments Yearbook. International Monetary Fund. Washington. Vol. 5, 1954.

TABLE 63

## UNITED STATES RECEIPTS FROM INTERNATIONAL TRANSACTIONS, 1946-1958

(Percentages of total receipts)

Year	Total Receipts	Receipts from merchandise and services	Receipts from foreign capital inflows
1946	100	107.09	-7.09
1947	100	98.67	1.32
1948	100	97.99	2.02
1949	100	99.55	0.44
1950	100	88.27	11.72
1951	100	97.52	2.77
1952	100	92.76	7.23
1953	100	95.05	4.94
1954	100	93.51	6.48
1955	100	93.89	6.10
1956	100	93.57	6.42
1957	100	97.68	2.31
1958	100	95.67	4.32

Source Computed from data presented in the *Survey of Current Business*, U.S. Department of Commerce.

TABLE 6.4

## UNITED STATES PAYMENTS FOR INTERNATIONAL TRANSACTIONS, 1946-1958

(Percentages of total payments)

Year	Total <sup>1</sup> Payments	Payments for Imports of Goods and Services	Payments for Unilateral Transfers	Payments for Capital Outflows
1946	100	50.35	21.71	24.90
1947	100	44.77	13.23	39.74
1948	100	59.13	27.61	11.08
1949	100	59.98	36.25	7.48
1950	100	73.90	27.56	8.71
1951	100	72.23	23.90	5.86
1952	100	70.43	23.06	7.08
1953	100	73.41	29.98	2.66
1954	100	71.30	24.03	8.76
1955	100	76.32	19.57	6.19
1956	100	70.59	17.71	12.84
1957	100	70.07	15.91	13.84
1958	100	77.92	8.00	14.17

method of determining this relationship is to express the payments for these items in terms of percentages of receipts from them. With receipts as a base, or 100 per cent, Table 6.5 shows payments as percentages of this base.

During the years 1946 through 1953, payments on account of merchandise tended to increase relative to receipts from them. In 1946 payments on this account represented but 43 per cent of receipts; by 1953 the percentage had risen to over 88. From 1954 through 1957, however, the percentage of receipts from merchandise exports represented by payments for merchandise imports declined, but rose in 1958. Generally speaking, during the post-World War II years foreign sales of merchandise did not keep pace with United States purchases of these items.

TABLE 6.5

PAYMENTS FOR ITEMS OF THE UNITED STATES MERCHANDISE AND SERVICES  
ACCOUNT AS PERCENTAGES OF THE RECEIPTS OF THE SAME ITEMS,

1946-1958

Year	Merchandise*	Transportation	Travel	Miscellaneous Services	Income on Investment
1946	43.33	33.18	177.82	33.18	27.46
1947	37.33	33.54	160.23	39.18	22.23
1948	57.32	49.05	194.80	39.20	20.69
1949	56.62	56.54	184.23	39.74	23.87
1950	56.62	79.18	185.45	39.97	21.65
1951	79.31	62.39	167.90	43.49	18.86
1952	81.37	74.93	158.70	42.49	21.33
1953	88.45	85.67	169.82	42.55	22.99
1954	80.80	87.61	172.77	52.70	18.81
1955	80.73	89.97	179.06	59.27	20.38
1956	73.67	85.74	180.85	49.95	22.21
1957	68.54	78.48	174.77	48.20	22.63
1958	79.78	66.90	176.96	48.28	23.13

A similar situation prevailed for transportation with imports of this item increasing relative to exports of it. United States imports of transportation climbed from 33 per cent of receipts in 1946 to almost 97 per cent in 1958. Except for small year to year variations, the percentage of travel exports represented by travel imports remained relatively the same. On the other hand, there was a slight tendency for payments for miscellaneous services to increase relative to receipts from them. Payments on income from investment, however, showed a decline as compared with receipts from this item.

*Trend of principal balance of payments items.* The trends of the more important groups of accounts on the United States post-World War II balances of payments are illustrated by the index numbers presented on Table 6.6.

The movement of exports of merchandise, services and capital during post-World War II years reflects both the effects of rising prices, resulting from monetary inflation, and the economic growth of the principal trading countries. The increase in imports of goods and services was especially impressive and has been one of the leading features of the United States external economy since the war. Such a development was to be expected, because this period marks the recovery of the trading world from the ravages of the war, a marked increase in its productive capacity and growth in American national income. The increase in exports has also been noteworthy, but it was not as great as that of imports.

TABLE 6.6

POST-WORLD WAR II TREND OF UNITED STATES EXPORTS AND IMPORTS OF  
GOODS AND SERVICES, UNILATERAL TRANSFERS AND  
CAPITAL MOVEMENTS

(Index numbers — 1952 equals 100)

Year	Imports of Goods & Services	Exports of Goods & Services	Unilateral Transfers	Foreign Capital	U. S. Capital
1948	44.30	71.55	58.34	217.80	-60.79
1947	52.02	95.61	51.58	504.18	18.43
1948	65.62	62.56	63.57	122.30	21.83
1949	61.58	77.60	113.66	78.36	4.46
1950	76.82	69.67	88.95	90.05	118.61
1951	96.04	96.16	97.08	77.56	35.85
1952	100.00	100.00	100.00	100.00	100.00
1953	104.69	102.92	130.56	37.83	68.81
1954	102.54	102.11	105.56	96.70	90.69
1955	114.11	106.71	89.46	92.20	88.69
1956	126.39	127.21	96.68	229.34	111.91
1957	129.35	141.17	92.52	261.91	42.86
1958	133.54	124.49	94.21	241.44	72.20

Source: Computed from data presented in *Survey of Current Business*, U. S. Department of Commerce

An important feature of the United States economy during these years was the institution and maintenance of several foreign aid programs. Lend-Lease was abruptly ended shortly after V-E day. In 1947, however, it was apparently decided that Europe required assistance, and that the Lend-Lease program had been terminated too soon. A new program was instituted (the Marshall Plan). After the European economies had been partially rehabilitated the Marshall Plan was terminated, and

successor foreign aid programs were instituted in the form of military assistance and aid to underdeveloped areas. Although the unilateral transfers account includes private as well as government transactions, the latter are by far the larger of the two. Since foreign aid programs reflect political considerations which often change, the movement of this account has been somewhat erratic. These programs started somewhat slowly in 1946, picked up momentum in 1948, and were especially heavy during the years 1949-1954.

The movement of both foreign and United States capital was even more erratic, responding as it does to a variety of factors such as savings, economic conditions at home and abroad, investment opportunities, the administration of exchange controls, and the movement of international reserves available for investment, among others. The flow of foreign capital into the United States was especially heavy in the immediate post-war years due, in part, to the flight of capital, but tapered off in 1949 only to regain momentum in 1956, 1957 and 1958 when it was especially heavy. Although the movement of United States capital was also erratic, a trend is discernible toward increasingly large American investments abroad.

*Composition of the current account.* Another important feature of United States balances of payments since the last war has been the change in the composition of the current account. To show these changes, total exports of merchandise and services have been used as a base, 100 per cent, and the component elements of this account have been expressed in terms of percentages of this base. The percentage distribution of these exports is presented on Table 6.7. A similar procedure has been followed in the case of imports of merchandise and services with total imports used as a base (100 per cent) and the components expressed in terms of percentages of it. The percentage distribution of the imports is given on Table 6.8.

Several interesting features of the post-World War II economy are illustrated by these tables. Commercial merchandise exports, or those which exclude military transfers paid for by the government, have been gradually assuming a somewhat smaller place and, in their stead, receipts from income on investments and military transfers under grants have been increasing. The proportion of total receipts represented by transportation and miscellaneous services has been relatively stable.

On the imports side, merchandise imports (excluding military) have declined in importance relative to the other components of this account, and their place has been taken by payments for military expenditures. The other components of these accounts have shown considerable stability.

TABLE 6.7

UNITED STATES BALANCE OF PAYMENTS  
1946, 1950, 1953, 1958-58

## Exports of Merchandise and Services

(Percentages)

	1946	1950	1953	1958	1957	1958
Exports of goods and services, total	100.00	100.00	100.00	100.00	100.00	100.00
Military transfers under grants	.46	3.65	20.13	9.81	8.34	9.81
Other goods and services, total	99.53	96.35	79.86	90.18	91.65	90.19
Merchandise, adjusted, excluding military	79.19	70.27	58.23	66.12	66.47	63.08
Transportation	9.35	7.17	5.79	6.24	6.85	6.41
Travel	1.73	2.72	2.47	2.68	2.69	3.20
Miscellaneous services	4.01	5.09	4.27	4.59	4.47	4.97
Military transactions	(1)	(1)	(1)	.60	1.27	1.15
Income on investments	5.22	11.06	9.22	9.93	9.87	11.36

(1) Prior to 1954, miscellaneous services, government, were not broken down to show government, excluding military and military transactions.

TABLE 6.8

UNITED STATES BALANCE OF PAYMENTS  
1946, 1950, 1953, 1958-1958

## Imports of Merchandise and Services

(Percentages)

	1946	1950	1953	1958	1957	1958
Imports of goods and services, total	100.00	100.00	100.00	100.00	100.00	100.00
Merchandise, adjusted, excluding military	72.99	75.58	66.49	64.57	63.52	61.79
Transportation	6.04	6.78	6.44	7.10	7.49	7.63
Travel	6.57	6.03	5.44	8.42	8.55	6.95
Miscellaneous services	3.67	3.96	3.46	4.06	4.17	4.07
Military expenditures	7.09	4.77	15.19	14.90	15.12	16.30
Income on investments	3.05	2.86	2.74	2.92	3.11	3.22

Source (for Tables 6.7 and 6.8) Computed from data presented in the *Surveys of Current Business*, U. S. Department of Commerce.

*U. S. balances of payments and international reserves.* Perhaps the most significant feature of the United States post-war balances of payments is the fact that they have been in substantial deficit since 1930. This deficit has been utilized by other nations to build up their international and banking reserves, which, since they utilize the dollar exchange standard, rely heavily upon dollars.

At the end of the war, the world was plagued by a dollar shortage and unless the United States had pursued balance of payments policies

designed to permit other nations to earn dollars, the levels of world trade might well have been restricted and some nations could have found it necessary to discriminate to an even greater degree against American imports in favor of those from the soft currency areas. As long as the world uses the dollar exchange standard and international trade continues to increase, the United States will doubtless need to maintain some deficits on its balances of payments.

At the present rate of growth of the imports of foreign nations and under the present proportions which they maintain between imports and dollar holdings, America's trading partners will require an estimated \$1 to \$1.5 billion a year in dollar earnings. These additional earnings can only be obtained if the U. S. continues, on the average, an annual balance of payments deficit of about this amount. Unless such a deficit occurs, the world may experience a liquidity crisis and the net effect upon both domestic and external economies would be deflationary.

*Concluding observations.* It should be evident now that there is no standard or normal balance of payments situation for all countries at all times. Universality in time and space is not a characteristic of these tabulations. The balances of payments of the United States give some evidence of the profound changes which have taken place since the war in its international economic relations. In the last few years the U. S. has been running a surplus on the current accounts and a deficit on the balance of payments as a whole. It has lost some ground and is still losing it, in the merchandise trade, but on the other hand it is gaining as an investor and as a recipient of investment income. If this trend continues the pattern will take on more profoundly the characteristics of a creditor nation on the capital accounts.

Another characteristic of the American post-war international economy is the large role which government unilateral transfers, grants and military assistance, have been playing. Although intermittent government grants have long occupied a place in the international economies of the better-off states, sustained economic and military aid of the type the United States is now rendering is a new development. These transfer payments support other receipts and they cannot be eliminated or reduced without making other important changes in the pattern of American foreign economic relations. For the foreseeable future, these government grants seem likely to remain a relatively permanent and perhaps even an increasing feature of the U. S. balances of payments.

Balance of payments analyses lie, of course, in the field of empirical studies. Much important work has been done in the past in the theory of international economics, and the theoretical relationships of the balance of payments accounts have been competently explored. To push out the

frontiers of positive knowledge and to obtain a better-rounded science, more work is needed in empirical studies.

The theoretical analysis of balances of payments, or the adjustment of international economic relations, is treated in chapter 16, in that part of this book reserved for the theory of international economics. From a technical point of view this part of the subject involves broader problems than those associated with the balance of payments and should be examined in the wider framework of the general theory of international relations. In Part III, which follows this chapter, the problem of international payments is discussed.

### QUESTIONS AND PROBLEMS

- 1 What facts can be learned (a) about a nation's external economy and (b) its internal economy, by an analysis of its balances of payments over a series of years?
- 2 Draw up an imaginary balance of payments for a country which derives 80 per cent of its receipts from the export of rice and spends 70 per cent of its payments for the import of agricultural machinery
- 3 What inferences may be drawn concerning changes in the international economy of the United States from the facts presented in the analyses of its balance of payments as presented in this chapter?
- 4 Assume that the United States abruptly placed an embargo on all its long-term investment abroad, both private and governmental. What changes might occur in its balance of payments?
- 5 If the United States desired to reduce the deficit on its balance of payments by \$5 billion, what steps should it take? Would a \$5 billion reduction in imports of merchandise accomplish this result? Why or why not?
- 6 In addition to the analyses of the United States balances of payments presented in this chapter, what other types of analysis might be suggested?
- 7 There is a close correlation between the national income of the United States and its imports of goods and services. What would be the possible effect on the total U S balance of payments of a large increase in national income?
- 8 Discuss the characteristics of United States foreign economic relations since the end of World War II
- 9 Why does the International Monetary Fund separate the oil transactions of Venezuela from the others?
- 10 Outline some of the effects on the international economic relations of the United States arising from its grant and loan programs

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as they grow or decline in response to balance of payments surpluses and deficits.

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## Financing International Transactions: Monetary Systems

"The balance of trade among states depends upon the quantity and management of money. Suppose that, of all those who desire to work, *half are employed and that the value of the commodities and merchandise shipped to foreign countries was equal to that of the foreign commodities and merchandise imported*, no payments balance would be due. If there was more money and it was well used, the other half of the supposedly unemployed would find work, the land would produce more, manufactures would develop, transportation of goods would be stronger and of greater value, foreigners would owe us a trade balance and specie or gold and silver would be brought into the country. On the other hand, if the quantity of money were decreased, some of those who were employed could no longer find work or would be employed at less profitable tasks, the land would produce less, the transportation of goods would be weaker and of less value, and, unless the state's consumption was proportionately decreased, a payments balance would be due to foreigners and specie or goods would be shipped out to pay for it."<sup>1</sup>

Thus John Law (writing about 1716), in a passage suggesting the theories of the late Lord Keynes, outlined the relationship of money and its management to the foreign trade of nations. Although monetary systems have not been developed generally with foreign trade in mind, the nature of that of each country has a strong impact upon its economic relationships with other nations. As trade developed and made greater demands on these systems, they were adjusted to enable them to handle it more effectively.

<sup>1</sup> Law, John, *Premier Memoire sur les Banques, Présenté à son Altesse Royale Monseigneur le Duc d'Orléans, Regent de France* Paris, France, (circa) 1716 Reproduced in Daure, Eugène, *Economistes Financiers du Dix-Huitième Siècle*, Paris, 1851. Pp 517-18

*Types of monetary systems.* There would be fewer foreign exchange problems if all nations used the same money. Under such circumstances there would be no greater payments problems involved in foreign than in domestic trade. In the real world, however, business is carried out by each country in its own money. When a resident of the British Isles sells goods abroad he wants to be paid in pounds sterling, because he must meet his payroll and pay many of his bills in pounds. Conversely, when he buys goods in the United States he must pay in dollars, because Americans need dollars for similar reasons.<sup>2</sup> The inability of a given country to import goods might not arise from the poverty of its inhabitants or from any lack of demand for foreign products, but from the fact that it is short of the requisite foreign exchange.

There has been considerable exchange of information and experience in monetary matters among nations. As one result, the world's monetary systems tend to follow certain general patterns. Those currency systems of principal interest today fall into the following groups:

1. The gold coin standard
2. The gold bar or bullion standard
3. The international gold standard
4. The gold exchange standard
5. The foreign exchange standards including three principal sub-systems:
  - a) The general foreign exchange standard
  - b) The sterling exchange standard
  - c) The dollar exchange standard

### The Gold Coin Standard

No country is today, or ever was, on the complete theoretically perfect gold coin standard. In the past many nations were on various forms of the gold coin standard corresponding more or less to the theoretical ideal, but these standards have now been abandoned by all the nations of the world.

In essence the gold coin standard is a system of money where all forms of currency and credit can be redeemed in gold on demand. All forms of money are therefore "as good as gold," which is the standard of value, the medium of exchange and the standard of deferred payments.

<sup>2</sup> The "key currency" is an exception to this general rule. Certain currencies such as the dollar and the pound sterling are in wide demand. It is possible to pay for imports in dollars or pounds in many countries. An amusing illustration of this fact was recently reported by a New York newspaper. An American traveller in a Scandinavian country paid for his purchases in a small retail store there in Confederate dollars, and it was only when the Scandinavian storekeeper took the Confederate currency to his bank that he discovered his mistake.

Gold is used as a store of value, and gold coins circulate freely. In some nations with strong popular preferences for gold, as in France before World War I, much of the circulating medium was made up of gold coins. In other nations, as in the United States before 1934, the inhabitants preferred the lighter and less bulky paper money, checks and other credit instruments.

*Gold, money, and prices.* Under the gold coin standard the reserves of the banking system consist of gold coins and bullion. The amount of gold which a nation possessed acted as a limit to the increase in credit, i.e. only that amount of credit money or instruments which could be redeemed in gold could be issued and sustained. Of course, a banking system could lower its reserve requirements and a given amount of gold could be bought to sustain a larger amount of credit, but there are limits below which a reserve cannot fall and the country still remain on this standard.

There are many cases in history where a nation has issued paper money in such quantities that gold reserves were insufficient to enable it to redeem the paper money in gold, and the nation has been obliged to abandon the gold coin standard. Declining gold stocks were generally held to be deflationary. Smaller reserves were often accompanied by declining amounts of money and credit, and falling prices frequently were one of the results. Deflation or falling prices, as we shall see subsequently, tend to improve a nation's export capacity and to reduce its capacity to import.

When a nation has large stocks of gold it can sustain proportionately larger amounts of paper money and credit. Increasing stocks of gold, therefore, may be followed by more money and credit in circulation and rising prices. Where increasing gold stocks are followed by rising prices, there is a tendency for exports to decline and for imports to increase.

Under the gold coin standard, there was a tendency for a nation's gold stock and the consequent volume of money and credit in circulation to be, in part, a function of its balance of payments. A nation running a deficit on its balance of payments frequently lost gold, its bank reserves fell and its money and credit declined in volume. A surplus on the other hand meant larger gold stocks, bank reserves and currency.

In the days of the gold coin standard, England was able to exercise considerable control over the flows of gold into and out of the Kingdom. When gold was flowing out this movement was braked by raising the Bank of England's bank rate, and when it was flowing in too rapidly this movement was curtailed by lowering the bank rate. With higher interest rates prevailing on the London market following a rise in the bank rate, England became a more attractive country in which to lend and con-

sequently funds from abroad were attracted to London, bringing about an inflow of capital. This created a demand for sterling and the gold outflows tended to decline. When the Bank of England lowered its rate capital tended to flow out of England to other financial centers where the interest rates were higher.

In the heyday of the gold coin standard, nations were expected to play the "gold standard game," a term believed to have been invented by Lord Keynes. According to the generally accepted rules of the game, which were only followed when countries found it convenient to do so, a country was supposed to permit gold inflows and outflows to have their full impact on the economy and either to refrain from measures designed to counteract these effects or to take positive measures to reinforce them<sup>3</sup>

### Gold Bar or Bullion and International Gold Bullion Standards

Prior to World War I, gold coin standard countries tended to guard jealously the convertibility into gold of their paper money and bills of exchange. For some nations, this standard was a symbol to be maintained at almost any cost. In addition to sentimental motives for adhering to the gold standard, there were sound business reasons which recommended it. The financial centers and institutions of these countries enjoyed the confidence of traders around the world, and these institutions were able to earn substantial sums in the form of fees and interest payments through the international transactions of other countries which were financed there.

*The gold bar and bullion standard* This monetary system is a less complete form of the gold standard than the gold coin standard. Under this system other forms of money, usually paper, are only redeemable in "wholesale" or large quantities instead of in any desired quantity as under the gold coin standard. Sometimes a further restriction is added when currency is only redeemed for external use or for export abroad and is not available for use on the domestic market. It is employed where countries which have been temporarily on a paper standard desire to resume the gold coin standard eventually and use it as a first step. It may also be employed where gold stocks have been so reduced as to make gold coin redemption inadvisable. As the following illustrations show, the United Kingdom has used it on more than one occasion.

During the Restriction Period, 1797-1823, Great Britain, in its efforts to finance the Grand Alliance against Napoleon, issued paper pounds to such an extent that the Bank of England was "restricted" by the law from

<sup>3</sup> For a short account of the rules of the gold standard game see, Bloomfield, Arthur I., *Monetary Policy Under the International Gold Standard*, Federal Reserve Bank of New York, 1959. Pp 47-51.

redeeming paper pounds in gold. At the end of the Napoleonic wars, the British strongly desired to resume specie payments. Upon the recommendation of David Ricardo the first step in the resumption procedure was the adoption, in 1819, of the gold bar or bullion standard. Under this standard, the Bank of England redeemed its notes in relatively large amounts in the form of gold bars rather than in coin. This procedure *economized and safeguarded the Bank's stock of gold yet made it available for international transactions.*

During World War I, the United Kingdom was obliged again to abandon the gold standard, but in 1925 it took the first step toward the resumption of specie payments by the adoption of the gold bar or bullion standard. Unfortunately, the rate of exchange of the pound was set at its old par, \$4 8665, which overvalued it and Britain's exports declined, production dropped and unemployment increased. In 1931 the United Kingdom again abandoned the gold bullion standard and has been on a paper standard ever since.

*The international gold bullion standard.* During the Great Depression of the thirties, President Roosevelt felt that prices had declined too far and consequently, in 1933-34, in the hope of raising prices, the dollar was devalued by increasing the price of gold from \$20 67 to \$35 00 per fine troy ounce. At that time, the United States abandoned the full gold standard and adopted a form of the "international gold bullion standard." Under this standard, gold coins were withdrawn from circulation. Private citizens were required to turn in their holdings of gold to the government and, except under certain limited conditions, were not permitted to deal in gold. Paper money was no longer redeemable in gold; gold certificates, instead of coin or bullion, were used as a reserve by the Federal Reserve Banks.

Under this standard, the federal government supplies gold on demand against dollars held by foreign government banks and official financial institutions at the official price of \$35 00 per fine troy ounce plus a small handling charge. It is not obliged by law to sell gold to foreign government financial institutions, but it has done so since 1934 as a matter of policy. Since gold in the form of bullion is made available internationally to official institutions, the standard is called the international gold bullion standard. The United States Treasury also stands ready to purchase all gold offered to it at the official price of \$35 00 per fine troy ounce, minus a small handling charge.<sup>4</sup>

<sup>4</sup> Two other monetary standards the silver standard and bimetallism, are not treated. They are solely of historical interest. Discussions of these standards will be found in the works on money and banking listed in the bibliography for this chapter.

## The Gold Exchange Standard

Some countries on a silver standard experienced difficulties in their foreign exchange due to the fact that their rates of exchange were not only subject to fluctuations arising out of changes in market demand and supply, but also to shifts in the gold price of silver and were relatively volatile. Other countries which employed paper money often found that their currencies were not well known or widely employed on the foreign exchange markets and discovered that their foreign trade could better be carried out in the currency of a larger and more important trading country. These countries could have overcome their disadvantages by adopting a gold standard, but resistance to monetary changes is great and such a change might have proved expensive.

The gold exchange standard was invented to solve the problems of remaining internally on silver or paper while at the same time enjoying the international advantages of gold. Under the gold exchange standard, silver and paper money continue to circulate in the interior of a country while a reserve of gold, bank deposits, or credit instruments readily exchangeable into gold, is maintained in some foreign country, at home or both. This reserve fund is drawn upon to make international payments and added to from international receipts.

*The Philippine gold exchange standard* In 1903, the Philippines, then on a silver and paper standard, adopted a form of the gold exchange standard. Silver pesos (worth U. S. \$0.50) and paper Philippine treasury certificates constituted the internal circulating media. An uncoined gold peso (also worth U. S. \$0.50) was adopted as the international or external currency. A Gold Standard Fund, partly held in a New York bank and partly in Manila, was established. Philippine importers requiring foreign exchange paid the Insular Treasurer, in charge of this Fund, Philippine silver or treasury certificates. He in turn purchased drafts in United States dollars—convertible on demand into gold—on a New York bank thereby reducing the Gold Standard Fund. These drafts were turned over to the importers who used them to pay for their imports. Since the Gold Standard Fund was also used as the banking reserve for national currency, these imports tended to have a deflationary effect by reducing the Fund's reserves.

Exporters offered foreign exchange drafts received in payment for their exports to the Insular Treasurer for deposit in the Fund in exchange for Philippine pesos. These drafts increased the Philippine Fund's holdings of foreign exchange reserves. These exports increased the Fund and also increased the amount of money in circulation. In the Philippines, at that time, the gold exchange standard behaved similarly to the gold

standard, with balance of payments surpluses tending to increase the money in circulation and deficits to reduce it.

*Later gold exchange standards.* Other forms of the gold exchange standard were adopted in the twenties by a number of European countries which did not desire to return to the full gold standard. These were of a different character from those of the Philippines and some other countries which were in effect prior to 1914. In the systems of the twenties the gold fund was managed by the central banks of those countries which utilized them. Credit policies were employed by the managers of the fund not only to safeguard the international and banking reserves but to prevent balance of payments surpluses and deficits from having their full impact upon the volume of domestic currency in circulation.

Exporters were not permitted to keep foreign exchange receipts arising from their sales abroad but were required to turn them over to the fund in exchange for domestic currency. Importers paid domestic currency to the fund and received foreign exchange drafts redeemable in gold, to use in paying for their transactions. Gold did not circulate internally but was used as a part of the reserves for international payments and the domestic currency. The central banks controlled the effects of the movements of foreign exchange upon domestic money and credit.

There are several forms of the gold exchange standard but all of them tend to fall into one or the other of the two types sketched above, i.e. those which operate like the gold standard, when the rules of the gold standard game are played, and those which are controlled and managed so as to prevent surpluses and deficits on the balance of payments from having their full effects on the volume of currency in circulation. One form or another of this standard has been used, at various times, by the Philippines, India, Holland, Russia, Austria-Hungary, China, many Latin American countries and the Straits Settlements, among others.

### Foreign Exchange Standards

Foreign exchange standards are but one species of a large genus: inconvertible paper money. As a monetary medium, paper money is of relatively recent origin. It probably came into use in Europe in the seventeenth century, although Marco Polo tells of seeing it used in China as early as the thirteenth century. John Law, the Scottish financier, cited in the opening paragraph of this chapter, was one of the early proponents of this type of money and advocated its use in the first decade of the eighteenth century.

*Characteristics of inconvertible paper money.* Paper money was at first convertible into specie on demand. It was issued by governments, central banks, private banks and individuals. It had the great advantage

of embodying large value in small bulk, was easily transported and concealed and served to facilitate trade.

The fact that it was not necessary to have a 100 per cent reserve in specie to maintain convertibility was discovered early in the use of convertible paper money. Hence, a given amount of gold and silver could support a much larger volume of money in circulation. This principle of reserve currency, or reserve banking, is now used by all modern nations. Reserve currency economizes the world's gold stock by making a given amount of gold do more work, gives the monetary system greater flexibility and makes it easier for governments and central banks to manage the money supply and system.

However, paper money is not without its hazards. Since full gold coverage is not required, there is a temptation to issue more and more, and unless the gold reserve is increased at a similar rate the reserve ratio drops lower and lower until finally the issuing nation or bank is obliged to abandon specie payments. If this happens, the nation may be said to have gone on an inconvertible paper standard.

The danger of inconvertible paper money lies, as many historical examples show, in the temptation to continue to issue it with a resulting upward pressure on prices. This danger is of course present in any monetary system, but it is greater with paper money. It is the danger of inflation. The principal disadvantage of inflation or rising prices is their disruptive effects upon the economy and the fact that all prices do not move at uniform rates or attain the same levels.

Rising, as well as falling, prices in a country have an important impact on foreign economic relations. As a general proposition, rising prices make it more difficult for a nation to export goods and services in the competitive markets of the world where prices asked by other nations may be lower. On the other hand rising prices facilitate imports. With high domestic prices domestic markets become attractive to the products and services of countries where prices have remained more stable. Conversely, falling prices have the opposite effects of making exports easy and imports more difficult.

*Foreign exchange reserves* Today's inconvertible paper money is generally supported by a reserve consisting partly of credit in the form of government obligations, partly of foreign exchange and partly of gold. The proportions of government obligations, foreign exchange and gold vary considerably from country to country and at different times. Where foreign exchange occupies an important place in the banking and currency reserves of a country, the volume of currency is in part conditioned by the surpluses and deficits on the country's balance of payments, much as it was under the older gold standards. Surpluses on the balance of

payments tend to increase the holdings of foreign exchange, the currency reserves and the ability of the country to issue more paper money. Deficits have the opposite effects.

The use of foreign exchange as a currency reserve has one important advantage over government obligations. The note issue of a government bank is a form of government credit. When it is supported by government securities one form of government credit is supporting another form; the government adds one promise to pay on top of another. Foreign exchange, on the other hand, represents the promise to pay of a government, one or more individuals, firms, or banks. A currency supported by foreign exchange reserves can be redeemed, to the extent of the reserves at least, by selling or collecting these foreign promises to pay.

Foreign exchange is not only the partial backing of the currency of many nations, it also constitutes a part of their "international reserves." These reserves, built up in times of balance of payments surpluses, are used to meet balance of payments deficits when and if they occur. Since it is unlikely that a nation would have a balance of payments in equilibrium year after year, an international reserve is required to meet deficits as they arise. These banking and international reserves of the world, by area, are shown on Table 7 1.<sup>5</sup>

Many countries combine their banking and international reserves into a single fund. Others, such as the United Kingdom, separate them. The international reserves of the United Kingdom are carried in its Exchange Equalization Account while the reserves of the Issue Department of the Bank of England include government obligations, but no foreign exchange. In the case of the United Kingdom, therefore, balance of payments fluctuations are not reflected in the Bank of England's note issue, and its credit and currency system is divorced (as far as bank reserves are concerned) from its foreign economic relations. In the case of some other countries, however, no distinction is made between banking and international reserves and the currency systems of these countries are interlocked with their external economic transactions.

*Types of foreign exchange standards.* The most important types of foreign exchange utilized as partial banking and international reserves are the dollar and the pound sterling, as Table 7 2 shows. The wide use of sterling and United States dollars in the world's monetary and international reserve systems and the important international role of these two currencies lead to the inference that sterling and dollar exchange are of such significance that present monetary systems may be termed either the sterling or the dollar exchange standard. The sterling exchange

<sup>5</sup> See, *International Reserves and Liquidity*, International Monetary Fund, Washington, D C, 1958, p 15

TABLE 7 1

RESERVE HOLDINGS OF GOLD AND FOREIGN EXCHANGE, BY AREA<sup>a</sup>  
1958

(In millions of United States dollars)

	Gold	Foreign Exchange	Total	% Foreign Exchange
World <sup>a</sup>	39,485	25,755	66,235	38.9
World minus U. S. <sup>a</sup>	18,903	25,755	45,653	60.3
Canada	1,078	870	1,948	44.7
Latin America	1,735	1,350	3,085	43.8
Continental EPU countries	10,040	8,035	18,075	44.4
United Kingdom	2,850	255	3,105	8.2
Other Sterling Areas	720	6,025	6,750	89.2
All other countries	1,060	2,850	3,905	72.9

<sup>a</sup> Excludes U S S R and Communist Bloc countriesSource: *International Financial Statistics*, International Monetary Fund, Washington, D. C., July 1960 Pp 21-23

TABLE 7 2

COMPOSITION OF GROSS FOREIGN EXCHANGE ASSETS<sup>a</sup>  
1957

(In millions of United States dollars)

	Value	Percent
Total <sup>a</sup>	18,050	100.0
Dollars	8,300	51.7
Sterling	5,833	36.3
EPU Liabilities <sup>b</sup>	1,269	7.9
BIS Deposits <sup>b</sup>	409	2.5
Errors and Omissions	239	1.5

<sup>a</sup> Exclusive of the U S S R. and the Communist Bloc nations<sup>b</sup> EPU refers to the European Payments Union and BIS to the Bank for International SettlementsSource: *International Reserves and Liquidity*, International Monetary Fund, Washington, D.C., 1958 P. 36

standard is utilized by members of the Sterling Area which consists, generally speaking, of all those countries which commonly use London as the financial center for their foreign transactions <sup>6</sup> Monetary and international reserves of the members consist largely of sterling. The dollar exchange standard is employed widely outside of the Sterling Area by those nations which keep a large part of their reserves in United States dollars.

*The dollar exchange standard* Since the United Kingdom maintains

<sup>6</sup> The Sterling Area is discussed in chapter 10.

much of the assets of its Exchange Equalization Account in gold and dollars, the dollar may be said to be the leading foreign reserve currency of the world today. This conclusion is reinforced by the fact that in 1957, 51.7 per cent of all the world's foreign exchange assets consisted of dollars. Given the importance of this currency today, present monetary systems (with certain exceptions) may be said to be on the dollar exchange standard.<sup>7</sup>

Since gold is of importance, the convertibility of the dollar into it by foreign government financial institutions serves to make the dollar attractive. The fact that the United States is a large source of goods, services and investment serves further to recommend the dollar as a reserve money. Its relative stability of value and extensive use in international transactions are other factors accounting for its popularity.

During the thirties, almost all of the nations which had used one form or another of the gold or gold exchange standards abandoned them and established inconvertible paper monetary systems. When the United States relinquished the gold coin standard in 1933-34, it adopted the international gold bullion standard. As far as a foreign nation's official holdings of dollars were concerned, the dollar was still almost as good as gold and the dollar grew in importance as a reserve currency during these years. During World War II, the Lend-Lease program supplied the Allies with badly needed dollars for imports at a time when their earnings of foreign exchange from exports were low. During this conflict, the use of the dollar as a reserve currency became even more firmly established. After the war the Marshall Plan and the successor aid and

<sup>7</sup> Miroslav A. Kriz, in his "Gold in World Monetary Affairs Today," *Essays in International Finance*, No. 34, June, 1959, published by the International Finance Section of Princeton University, takes the position that the world is still on a form of the gold standard. In support of his position, Kriz gives an institutional definition of the gold standard and points out that many of the nations of Western Europe still maintain the bulk of their currency and deposit reserves in the form of gold. However, monetary standards are as much a matter of generally accepted definition and concept as they are of the composition of reserves. Unless the definition of the gold standard were changed importantly, the foreign exchange standard (with the dollar exchange standard as its principal type) better describes the monetary systems today. Robert Triffin, in his contribution, *Gold and the Dollar Crisis*, Yale University Press, New Haven, 1960, refers to the present monetary standards as gold exchange standards and develops this thesis on pp. 64-70 of his work. In view of the fact that no country whose currency is used as reserves is still on the gold coin standard and that other motives in addition to gold convertibility underlie the use of the dollar, the present monetary systems are better characterized as foreign exchange or dollar exchange standards. On the other hand, Klopstock, Fred H., in "The International Status of the Dollar," *Essays in International Finance*, No. 28, May, 1957 published by the International Finance Section of Princeton University, takes the position that the world is on a dollar exchange standard. Klopstock's argument is generally similar to that presented in this chapter. See especially pp. 3, 25-26.

grant programs served further to popularize the dollar as an international currency.

*The dollar exchange standard, and gold outflows.* Between 1945 and 1958 the deficits on the United States balances of payments may be said to have been purposeful for these were the days of the "dollar shortage," when nations which used the dollar exchange standard experienced a shortage of this international currency. These deficits, of small magnitude, aided the dollar-short nations of the world to reconstitute their banking and international reserves. In 1958 the picture changed abruptly. In that year the deficit on the United States balance of payments amounted to \$3.5 billion and foreign central banks, instead of adding this amount of dollars to their reserves, took \$2.3 billion of it in gold. In 1959 the deficit amounted to \$3.8 billion and foreign nations asked for and received \$700 million in gold. In 1960 a total deficit of \$3.8 billion occurred with foreign government financial institutions taking \$1.7 billion in gold. The monetary gold stock of the United States, which stood at \$24.6 billion in 1949, had declined to \$17.8 billion at the end of 1960—a drop of \$6.8 billion in eleven years.

The gold outflows beginning in 1958 aroused the government and the people of the United States to one of the dangers inherent in the dollar exchange standard. If other nations continued to redeem their dollar holdings in gold it would be but a question of time until the gold stock of the United States was reduced below the statutory limit of 25 per cent of the demand obligations of the Federal Reserve Banks, and this country might be obliged to abandon the international gold bullion standard. This threat is aggravated by the fact that as long as other nations continue to use dollars as a substantial part of their international reserves and if they maintain the same proportion of dollars to imports increasing at current rates, they will require from \$1 to \$1.5 billion in additional dollar assets each year.

In view of these circumstances, the federal government took steps to reduce the deficits. These measures included export promotion drives, reductions in the amounts of goods which American travellers abroad were permitted to bring home duty free, proposals to tax some of the hitherto tax-free earnings of certain United States business subsidiaries abroad, arrangements whereby recipients of American grants and loans were obliged to spend the proceeds in the United States, reduction of the favorable federal government emphasis on private investment abroad, and wider use of American shipping, among others.

While all of these measures are steps in the right direction, some authorities believe that they are too limited in scope and that they do not attack the fundamentals of the problem. According to this view, in

order to come to grips with the problem, the U. S. must bring other nations to play the "dollar exchange standard game," modify or strengthen the standard or abandon it in favor of some other one.

*Rules of the dollar exchange standard game.* Just as the old gold coin standards postulated certain rules of the game, there are likewise rules of the dollar exchange standard game. As far as the United States is concerned, the rules require it to maintain the international official convertibility of the dollar into gold, to hold the price of gold at \$35 per fine troy ounce, to refrain from inflation, to promote price stability; to avoid recessions and to continue to make it possible for users of this standard to accumulate sufficient dollars for their domestic monetary and international reserve requirements.

The rules of the game require foreign countries which employ the dollar exchange standard to refrain from accumulating dollar assets in excess of their needs, to open their markets to United States exports and investments so as to permit this country either to balance its payments or keep its deficits down to manageable proportions, to utilize dollar holdings in preference to gold in their banking and international reserves; to allow the United States to be the principal repository of the world's gold, to assist in programs of economic aid to the underdeveloped lands, to assume their share of military burdens imposed by Russian and Communist Chinese threats of aggression. Other rules which apply both to the United States and the user-countries require the maintenance of healthy economies, sustained and substantial rates of economic growth and the reduction of restrictions to the free movement of international trade.

As previously noted, the rules of the old gold standard game were broken almost as frequently as they were followed. The world has made considerable progress, however, in international cooperation since the days of the gold standards so that now international conferences among the users of this standard might be held to obtain agreement and adherence to a body of such rules. *In other words, the dollar exchange standard needs to be codified and institutionalized.*

Among the several plans which have been advanced for replacing or strengthening the dollar exchange standard, those of Professor Robert Triffin and Dr. E. M. Bernstein are of special interest. In addition, the pages following note certain trends already manifest in the dollar exchange standard which could strengthen its character.

*The Triffin proposal.*<sup>8</sup> In *Gold and the Dollar Crisis*, Robert Triffin calls attention to the fact that under the dollar exchange standard the world will require increasing amounts of dollars for reserve purposes,

<sup>8</sup> Triffin, Robert, *Gold and the Dollar Crisis*. New Haven, Conn.: Yale University Press, Rev. ed., 1961.

and it might be beyond the power of, or at least imprudent for, the United States to continue to meet this demand. The world may face a liquidity crisis with international reserves failing to keep pace with the world's need for them. To meet these problems, Triffin suggests a change in the character of the International Monetary Fund to enable it to function as a government central bank's bank, i.e. to act toward government banks as the Federal Reserve Banks and the Bank of England do with respect to the commercial banks of their countries. Nations would cease using dollars as their banking and international reserves; they would deposit their foreign exchange holdings in the Fund and use these deposits as their international reserves. The Fund would manage these deposits like a central bank manages those of the commercial banks, providing for controlled expansion to meet the growth potentials of the world economies.

Triffin's plan resembles in some respects that put forward by Lord Keynes in 1943 for an International Clearing Union. One of the reasons for the rejection of Lord Keynes' proposals for a government bank's central bank, in favor of the type of institution adopted at Bretton Woods, was the fear on the part of the American delegation to this meeting that his proposals might have failed of ratification by the American Senate. If an amendment such as that proposed by Triffin would delegate to the Fund any limitation of the control which Congress and the executive have over the United States monetary system, the prospects for ratification appear to be doubtful.

*The Bernstein plan.* A different proposal has been made by Dr. E. M. Bernstein, formerly Director of Research of the Fund, at the seventy-third Annual Meeting of the American Economic Association held in St. Louis in December 1960.<sup>9</sup> Bernstein's plan involves a wider use of Article VIII, Section 4, of the present Fund Articles of Agreement. According to this Article, a member is obliged to convert official balances of its currency, held by another member, either into gold or into the currency of the country requesting the conversion. By obliging a member nation to redeem United States holdings of its currency in either gold or in dollars, the dollar assets of these members could be reduced and the pressure on the American gold stock relieved.

Since transactions of this nature would involve large amounts of the leading currencies, the Fund could enter into agreements with the substantial holders of foreign exchange reserves envisaging the loan to the Fund of certain amounts of their own currencies. These members would agree, according to the Bernstein plan, to subscribe to specified amounts

<sup>9</sup> See Bernstein, Edward M., "The Adequacy of United States Gold Reserves," *American Economic Review, Papers and Proceedings of the Seventy-third Annual Meeting of the American Economic Association*, May, 1961 Pp 439-446

of loans of their currencies to the Fund. In return, the Fund would give them an interest-bearing note with payment in gold guaranteed. The members of the Fund would be called upon to take up all or a part of their agreed subscriptions if and when the Fund felt that another member needed their currencies to meet an important outflow of funds or was faced with large demands for the conversion into gold of its currency.<sup>10</sup>

The Bernstein plan represents an extension and development of some of the powers which the Fund already possesses and which could be put into effect by an amendment to the Articles of Agreement as provided by Article XVII. Additional enabling legislation would probably be required on the part of the United States and some other countries to permit the Fund to borrow dollars and other required currencies.

*Dollar exchange standard trends* The United States has not had recourse to the facilities which the Fund offers because, until the gold outflows of 1958, its balance of payments and its currency were not under heavy international pressure. Many other countries have utilized their drawing rights, to tide them over periods of foreign exchange shortages. Generally stated, these rights permit member countries to draw on the Fund for the currencies of other nations against the deposit of their own money when they face temporary balance of payments difficulties. The foreign currencies so drawn must be replaced by the member which drew them within specified intervals of time. For example, if the United Kingdom were short of dollar exchange for its international transactions, it could draw specified amounts of dollars from the Fund against the deposit of its own currency.

Resources of the Fund, adequate perhaps when it was established in 1944, were increased by 50 per cent in 1959. In 1961 many members felt that the reserves were still inadequate to meet its full responsibilities including the balance of payments deficits of the United States. The United States plans to use its drawing rights on the Fund to avoid further gold outflows and the Fund is arranging to increase its potential holdings of world currencies by borrowing them from the member nations somewhat as Bernstein proposed. In the case of the United States, if further deficits occur and additional gold outflows threaten, it will be in a position to draw foreign currencies from the Fund against the deposit of dollars, present these currencies to other members and ask for dollars or gold in exchange. Deprived of some dollars, these member countries can no longer demand such large amounts of gold from the United States Treasury.

Some nations have started to diversify their reserve holdings of

<sup>10</sup> *Ibid* Pp 445-446.

foreign currencies by adding marks, liras and guilders. In addition, the United States has been building up its stock of marks and Swiss francs. If this trend continues the dollar exchange standard may gradually give way to a more general foreign exchange standard, with nations utilizing a more diversified portfolio of foreign exchange. With more varied reserve holdings, some of the pressure on the dollar may be relieved and the threat to the gold holdings of the United States reduced. If other countries could give a guarantee against devaluation or if they would agree to redeem official holdings of their currencies at the par value on the date they were acquired, their moneys would become more attractive as reserve holdings.

*Some remaining issues.* With very large deficits, there is a tendency for foreign dollar balances to grow beyond required proportions, to become redundant and for the holders to prefer gold in their place. Reducing the size of United States deficits thus alleviates the pressure on its gold stock. Some of the Governors of the Fund, meeting in Vienna in 1960 declared that the recent deficits are the reflection of domestic recession and will decline with the improvement of the economy. Contra-cyclical measures, it was stated, might be effective in reducing these deficits since they attack the fundamental disequilibria which brought them about.<sup>11</sup>

There are several reasons for transforming dollar holdings into gold. Some official financial institutions traditionally maintain a certain fraction of their reserves in gold. As their total reserves increase, their demand for gold likewise grows. The substantial deficits on the United States balances of payments since 1958 may have served to undermine confidence in the stability of the dollar and have fed the fears that it would be devalued by raising the price of gold. Nations which entertain doubts of this type would like to convert dollars into gold at a price of \$35 rather than at some new higher price, because a given amount of dollars would bring more gold at the former than at the latter price.

*Advantages and disadvantages of the dollar exchange standard.* In the absence of adequate stocks of gold, nations must find something of value to use as reserves. As far as the banking and domestic currency reserves are concerned, it is not necessary to use either gold or foreign exchange, government securities can be used for this purpose, and in some countries they are. The international reserves of a country require, however, instruments which can be transferred readily into the money of other countries to meet balance of payments deficits. The use of dollars

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<sup>11</sup> See the *Monthly Review* of the Federal Reserve Bank of New York, October 1961, Vol. 43, No. 10, pp. 167-169.

for this purpose has certain advantages and disadvantages for the United States.

Since the dollar is its own money, it is not likely to run short of dollar reserves. As far as the means of payment are concerned, the United States has some latitude of action and if it desired could exercise influence over the monetary systems of other countries. On the other hand the dollar exchange standard imposes some obligations on the United States, which were listed in an earlier paragraph. The responsibilities which it imposes limit freedom of action on internal matters. Many nations face the choice of sacrificing their domestic to their external economies or vice versa. With the use of the dollar exchange standard, the United States, if it recognizes its responsibilities, will need to manage its internal economy in the light of its external monetary obligations. Under the dollar exchange standard the United States is not only its own banker but is banker to the rest of the world, and its gold stock in addition to being its own reserve forms a part of world gold reserves.

As international banker to the world, America is in a similar position to that of every banker except that it is not able to replenish its reserves (in this case gold) in sufficient quantities to meet demand liabilities. The situation, therefore, holds some danger for this country. The dollar exchange standard appears likely to be buttressed by drawings on expanded Fund facilities, by measures such as Bernstein has proposed, and it may also give way to a more general foreign exchange standard with the dollar continuing to occupy a preponderant position in the composition of these more diversified reserves.

The next chapter describes how, within the framework of an international currency, the international business of the world is financed and sketches the several means used to pay for exports and imports of goods and services, unilateral transfers and capital movements.

## QUESTIONS AND PROBLEMS

- 1 After consulting the appropriate works listed in the bibliography, describe briefly the silver standard and bimetallism
- 2 Explain why a monetary system is important to a nation's foreign economic relations
- 3 Explain how the dollar exchange standard came into being
- 4 What would be the effects of a severe period of monetary inflation and rising prices in the United States upon the world's economic relationships?
- 5 Many people favor a return to the gold coin standard because they believe that monetary stability is best achieved by this system. List reasons for and against this proposal
6. Would a central bank's bank be preferable to the present dollar exchange standard? Why or why not?

7. What might be the effects of a severe and prolonged depression in the United States on world monetary standards?
8. What are the differences between the gold coin standard and the international gold bullion standard?
9. Since there is much more silver than gold in the world today, why was silver abandoned as a monetary standard?
10. If interest rates were to rise in the United States to higher levels than those in other monetary centers, what are likely to be the effects on the United States gold holdings?

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## Financing International Transactions: Methods

"Bills of exchange," said John Stuart Mill, "were first introduced to save the expense and risk of transporting the precious metals from place to place . . .

"Bills of exchange having been found convenient as means of paying debts at distant places without the expense of transporting the precious metals, their use was afterward greatly extended from another motive. It is usual in every trade to give a certain length of credit for goods bought three months, six months, a year, even two years according to the convenience or custom of the particular trade. A dealer who has sold goods, for which he is to be paid in six months, but who desires to receive payment sooner, draws a bill on his debtor payable in six months, and gets the bill discounted by a banker or other money-lender, that is, transfers the bill to him, receiving the amount, minus interest for the time it still has to run. It has become one of the chief functions of bills of exchange to serve as a means by which a debt due from one person can thus be made available for obtaining credit from another."<sup>1</sup>

*Definition of bill of exchange* This instrument may be briefly defined as an unconditional order in writing, addressed by one person to another, signed by the person giving it requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a certain sum in money to, or to the order of, a specified person or to bearer.

Although the bill of exchange has been generally used in Europe for a long time, it has not been widely employed on the American domestic markets. Our practice has been to sell on open or book account, and a buyer who receives a bill of exchange or draft for acceptance from the

<sup>1</sup> Mill, John Stuart *Principles of Political Economy* Edited by W. J. Ashley London, 1920, pp 515-516

seller is quite likely to feel as though he has been insulted by having his credit-worthiness questioned by the use of such a document.

When Americans first engaged in foreign trade they found the bill of exchange accepted as the almost universal means of effectuating foreign payments and extending credit. They fell into the custom of the trade and used these bills for foreign transactions. They learned that no stigma is attached to their use in foreign commerce. Today, the American foreign trader and the banker who helps finance his transactions are quite adept in their use.

### Financing United States Imports of Merchandise: The Bill of Exchange

*An import transaction* The use of the bill of exchange in modern foreign trade can be illustrated by an example. Assume that an American manufacturer of high-quality men's clothing decides that the fall and winter market will be good for men's tweed clothing. He sends one of his buyers to England to look over the tweeds which the British mills are producing. The buyer finds a line which pleases him and places an order with the mill for tweeds having a total value of £100,000 which, at the prevailing rate of exchange of £1 equals \$280, will cost the American clothing manufacturer \$280,000.

The buyer works out the details of the transaction with the British mill: the terms, delivery dates, packing, shipping and insurance arrangements, among others. The British mill agrees to allow the American firm ninety days after the acceptance of the draft for payment.

*Payment by bill of exchange.* In due course the British mill has manufactured the tweeds, packed them for shipment, insured the shipment against marine and other risks, obtained a consular invoice from the American Consulate, loaded the tweeds on board a vessel bound for New York and obtained an ocean bill of lading from the steamship company. The British mill then draws a draft on the American clothing manufacturer, attaches all of the documents mentioned in this paragraph to it and takes it to its bank for handling. This draft, or bill of exchange, would be drawn for £100,000 and be payable ninety days after sight. It might well take the form of the bill of exchange reproduced on Chart 8 I.

The British mill's banker then forwards the bill, with all of the documents attached, to its branch or correspondent bank in New York. Upon receipt of the bill, the New York bank notifies the clothing manufacturer that it has a bill drawn on him and presents the bill for acceptance. If all the documents are in order the clothing manufacturer accepts the bill by writing the word "accepted" across the face of the

bill, the date and place of acceptance and then signs it. A form of acceptance is also shown on Chart 8 1

The New York bank detaches the documents from the draft and hands them to the importer. If the American clothing manufacturer declines to accept the draft, he will not, of course, receive the attached documents and cannot obtain the goods from the steamship company. Without accepting the draft he cannot obtain possession of the goods. This is the great protection which the bill of exchange affords the exporter, he retains his goods until the importer has accepted the bill and has obligated himself to pay it.

In the case at hand the documents were given to the drawee—the American clothing maker—of the draft upon his acceptance of it and such a draft is known as a D/A, or documents upon acceptance, draft. The drawer, or the British mill, evidently had faith in the clothing manufacturer and felt that he would pay the draft upon maturity. If the drawer felt that the draft might not be paid when it fell due, he might have used a D/P, or documents upon payment, draft. Under a D/P draft, the documents are not given to the drawee upon his acceptance, but only upon

payment. With such a draft the drawee cannot obtain possession of the goods until the draft is paid.

Another advantage of this instrument to the exporter is that the bill constitutes, in itself, a legal obligation to pay the stipulated sum at a stipulated time and place. In case of non-payment, the owner of the bill, in this case the exporter, sues on the bill itself. He is not obliged to prove in court that the importer bought the goods and agreed to pay under certain conditions. The accepted bill alone is a legal obligation to pay.

*Negotiating the bill* With the acceptance of the bill, the British mill now has a negotiable instrument and has several courses of action open to it. The mill can hold the bill, or allow the London or New York bank to hold it for them, for collection at the expiration of the ninety days "usage" which the bill has to run. If the mill has sufficient working capital and no immediate use for funds, it might do this.

On the other hand, if the mill desires the funds at once it can sell, or discount, the bill. There is a very active market for these bills in London, New York and other financial centers. A bank in either New York or London will ordinarily purchase the bill provided it is in good order and the reputations of the drawer (the British mill) and of the drawee (the American clothing manufacturer) are good. A bill broker or dealer might also purchase it and even a private individual who has a payment to make in pounds sterling of like amount would be another potential purchaser.

Anyone who buys the bill will discount it, that is, he will pay the face value of the bill minus the going rate of interest for instruments of this type. For sake of argument, assume that the market rate for bills of this type is 4 per cent. Four per cent of £100,000 for ninety days would be 1 per cent of the face value and the discount would thus amount to 1 per cent of £100,000 or £1,000. Since the discount is taken out in advance, the purchaser will pay the mill £99,000, or its equivalent in other currency, for the bill.

What does the bank or bill broker who purchases the bill do with it? He can hold the bill for ninety days and earn the 4 per cent interest, or £1,000, which it carried. What will he do with the pounds sterling at the expiration of the usage of the bill, or the time which it has to run, and after it has been paid? There are many Americans who import goods and services from Britain and who will be glad to purchase all or a part of these pounds in order to meet their own payments due in pounds sterling. He might also use the pounds to invest in British notes and securities. A bank which has customers who need pounds is another potential purchaser of it.

If the rate of interest on bills of this kind were to decline during the

life of the bill after it had been discounted at 4 per cent, the purchaser might sell it and realize an immediate profit. To illustrate this point, make the unrealistic assumption that the rate of interest drops the same day that the bill is discounted at 4 per cent, and while the bill still has ninety days to run, to 2 per cent. Two per cent a year is one-half of one per cent for ninety days and, on £100,000, amounts to £500, the bill can sell for £99,500. The purchaser at the rate of 4 per cent would thus have an immediate profit of £500, since he paid but £99,000 for the bill.

It should be noted that if the bill were sold or discounted on the New York market, the transaction would probably take place in dollars at the going rate of sterling-dollar exchange. So if the British mill desired to receive dollars for this bill, they would doubtless sell it in New York. On the other hand if the transactions took place in London the bill would in all probability be bought for pounds. If the mill desired to receive pounds at once, it might sell the bill on the London market. What the mill would actually do would depend upon when it desired to recoup the selling price of the tweeds, the applicable rates of exchange and discount rates.

*Paying the bill.* So much for the problems of the British mill. What about the American clothing manufacturer? Having signed the bill he has been given the documents, and with the ocean bill of lading he can claim the tweeds from the steamship company. If they have been damaged, the insurance policies provide indemnity for the losses covered. Before the manufacturer can bring the tweeds into the United States he must pay, or "liquidate," the customs duties applicable to this type of merchandise. So, he pays the duties assessed on the tweeds and ships them to his factory to be made up into men's clothing for the coming season.

Ninety days from the date the bill was accepted, he must find £100,000 to meet the draft. He faces two problems. He must find someone who has £100,000 for sale, and he must be able to pay for them. Today, locating a potential seller of pounds sterling is but a small problem. Most of the banks which engage in foreign exchange have pounds for sale and bill brokers are usually well supplied with them. These banks and brokers get the pounds, among several possible ways, by buying them with dollars from British banks and dealers. Since British banks and dealers have customers who need dollars to pay for imports from the United States, they exchange pounds for dollars. Another American bank or a broker might also be a source of the pounds because they have sterling available from the proceeds of sterling bills which they have bought from other traders.

*Forward exchange.* Although locating a seller of pounds sterling

generally presents no difficult problem, the price at which they can be acquired is another factor to be considered. It was assumed when the clothing manufacturer bought the tweeds that the sterling rate of exchange was at par or \$2 80. Based upon this price, the clothing manufacturer assumed that the tweeds would cost \$250,000 and he priced his garments accordingly. His salesmen have already taken orders for fall delivery on this basis

But exchange rates fluctuate and the British authorities, through the Exchange Equalization Account, allow the pound to vary between the limits of approximately \$2 78 and \$2 82 to the pound. If the pound were at its lower limit of \$2 78 when the bill fell due, the American clothing manufacturer could meet his obligation by buying £100,000 for \$278,000 and make a windfall profit of \$2,000. But if the price were \$2.82 on the date of the bill's maturity, the clothing manufacturer would have to pay \$282,000 and would be out of pocket \$2,000.

By accepting the bill the clothing manufacturer became an unwitting speculator in foreign exchange, unless he took the proper precautions. He could have avoided possible loss by hedging his transaction. These hedging operations take the form of the purchase or sale of "forward exchange." In this case, when he signed the contract for the purchase of the goods the clothing manufacturer should have agreed, or taken an option, to buy £100,000 from a bank or dealer deliverable in ninety days, at the current rate on the date of the agreement, for bills payable upon sight, plus or minus a small differential representing the market situation for this type of forward exchange. In this way, the importer would have fixed definitely the dollar cost of the pounds at the time he closed his deal.

A bank engaged in the foreign exchange business must be willing to buy or sell forward exchange to accommodate its customers, and this business can be a source of considerable profit to the bank. To engage in this type of business, banks either maintain an inventory of the exchange of all countries with which their customers do business or know where they can obtain it rapidly and are usually able to sell it on demand. In the present case the bank would agree to deliver future or forward exchange on the date the American clothing manufacturer specified, and payment would usually be made when the manufacturer took delivery of the pounds from his bank.

The bank does not speculate in foreign exchange as might appear, because the bank which sold the forward exchange deliverable in ninety days would immediately cover its "position" by the purchase of an equivalent amount. Since the bank charged the customer slightly more than it was obliged to pay for the covering exchange, it made a profit on the transaction while taking but little risk. In addition to selling forward

exchange for future delivery to customers, banks also purchase forward exchange from customers for future delivery to the bank. Thus if an American exporter sold goods to a British importer providing for payment in pounds at some future date, a bank dealing in foreign exchange might purchase the pounds against dollars as soon as the transaction was closed.

### Financing United States Imports of Merchandise: The Letter of Credit

Before the British mill extended ninety days credit to the American clothing manufacturer, it had to assure itself that this importer was credit-worthy by conducting a credit investigation or by using the credit information of its bank or a mercantile credit agency. If the mill were not entirely satisfied with the clothing manufacturer's credit reports, it could still extend ninety days credit with a minimum of risk through the device known as a letter of credit.

*A letter of credit transaction.* A letter of credit is an instrument whereby a bank agrees to allow one party to the transaction—in foreign trade, usually the exporter—to draw on it or its correspondent in favor of the exporter and agrees to accept, or have its correspondent accept, the drafts drawn by the exporter. In the example above the American clothing manufacturer goes to his bank, explains the transaction to one of the bank's officers, submits the necessary financial statements and other documents designed to establish his credit standing and makes arrangements to pay the bank for the drafts as they fall due and are paid by the bank. He can repay his bank in at least two ways, by making an appropriate deposit, thus paying in cash, or by borrowing the money from the bank and substituting his obligation on a note for that on the letter of credit.

When the financial arrangements have been made, the bank issues a letter of credit in favor of the British mill for the amount agreed upon (£100 000). It contains the conditions and terms of the contract between the mill and the manufacturer. The bank will only honor drafts drawn on it by the British mill which meet these terms and conditions. The clothing manufacturer pays the bank a fee for the letter of credit, usually between one fourth and one-sixteenth of the face value of the letter of credit with the modal rate for good customers of one-eighth of one per cent.

The issuing bank sends the letter of credit to one of its branches or correspondents in London, for transmittal to the exporter, and also a letter of advice to the British mill stating that a letter of credit has been issued in its favor subject to certain terms and conditions. Bills (accom-

panied by the appropriate documents) under the letter of credit are drawn by the British mill on the correspondent or branch bank when the tweeds are shipped and are presented for acceptance to this correspondent or branch bank. On acceptance, the documents are forwarded to the American clothing manufacturer through the bank which issued the letter of credit originally.

At the expiration of ninety days after sight, the American clothing manufacturer's bank is obliged to pay the £100,000 bill or make arrangements for its payment. Ordinarily, it would have instructed its London branch or correspondent—and so advised the British mill—to pay the bill at maturity and to charge the £100,000 to its account. In this way, at the end of the transaction the American bank would have had £100,000 less on deposit in England. The American clothing manufacturer would have to pay his bank the dollar equivalent of the draft (\$280,000 in this case) and he could do this by either having his bank charge his account with this sum or by borrowing the money from the bank to meet this payment. The American bank, although it would have £100,000 less in its deposits abroad, would have \$280,000 more in either cash or loans as a result of the transaction.

*Types of letters of credit* A letter of credit may be either confirmed or unconfirmed, revocable or irrevocable. Under a confirmed letter of credit, the issuing bank advises the British mill that it will assume responsibility for all bills drawn under the letter of credit and thereby adds its credit to that of the correspondent bank. In the event that the correspondent bank is little known or of doubtful credit standing, this notice of confirmation is important because it adds the importer's bank's liability for payment to the transaction. When the letter of credit is unconfirmed the issuing bank does not advise the drawer that it assumes responsibility for payment, and thus responsibility rests with the branch or correspondent bank.

Under an irrevocable letter of credit, the obligation of the issuing banks is absolute, they cannot change their minds during the course of events and cancel the credit. Where the letter of credit is revocable, the issuing bank may revoke the authority to draw bills at any time and without notice. An irrevocable letter of credit is thus preferable. A confirmed, irrevocable letter of credit is the best of all.

*Advantages and disadvantages of the letter of credit* The British mill has now a bill accepted by a bank and no longer needs to rely upon the credit of the American clothing manufacturer for payment. Such a bill is a better credit instrument than one accepted by the clothing manufacturer alone and will be discountable at a lower rate of interest. The letter of credit has another advantage in that only bills and their accom-

panying documents which conform in every detail to the terms and conditions of the letter of credit will be accepted or paid.

On the other hand, the letter of credit lacks flexibility. Any change in the import-export transaction which takes place after the letter of credit has been issued must form the object of an amendment to it, which makes this instrument somewhat clumsy when many changes occur in the transaction. The letter of credit is well adapted to routine types of exporting and importing, but it is not a suitable instrument to employ where flexibility is required and where the transaction takes unusual and little used forms.<sup>2</sup>

*Some financial effects of the bill.* It is important to note that, whatever the method of financing, the American importer added to the United States demand for pounds sterling in the amount of £100,000. In paying the bill when due, if the pounds were purchased in Britain, this transaction increased England's holdings of dollars because dollars were tendered the British bank in exchange for the pounds. If the pounds were purchased from a United States bank's holdings of pounds in exchange for dollars, then its supply of British pounds declined. The appropriate balance of payments accounts affected by transactions of this type were outlined in chapters 3 and 4. The next chapter indicates the impact of this type of transaction on the rate of exchange.

### Financing United States Exports of Merchandise

*An export transaction.* A British manufacturer of electric refrigerators finds, on one of his trips to the United States, a fractional horsepower electric motor which suits his requirements better than any British or other motor. After planning his production program, he places an order for motors having a total value of \$250,000 with the American manufacturer. Since his financial position is strong, he agrees to pay cash for the motors upon delivery. The other terms of the purchase are agreed upon and the American motor maker proceeds to manufacture them. When the motors are finished, the factory packs and ships them, obtains a consular invoice from a British Consul in the United States, an ocean bill of lading from the steamship company and marine insurance from the agreed insurance company.

The American motor manufacturer then draws a bill of exchange, or draft, "at sight" on the British importer for \$250,000, attaches the above documents to the draft, and turns the draft and the attached documents over to his bank in New York for handling. The bill and the documents are forwarded by the New York bank to its London corre-

<sup>2</sup> Cf. Wasserman, Max J., "United States Import Financing Methods," *The Journal of Finance*, Vol. VI, No. 3, Sept. 1951, pp. 325-328.

spondent bank or branch which presents them to the British importer. This bill must be paid, rather than accepted, for it is a sight draft payable as soon as it is "seen" by the drawee. If the British importer pays the bill, the documents are detached and turned over to him and he can then claim the motors from the steamship company, clear them through British customs and use them in his manufacturing operations.

*Letter of credit payment for export.* This transaction could have been handled under letter of credit financing just as the United States import of tweeds was. In this case, the British refrigerator manufacturer arranges with his bank to issue a letter of credit in favor of the American electric motor manufacturer. The importer's bank in London forwards the letter of credit to its correspondent bank in New York, spelling out the terms and conditions of the transaction, for transmittal to the exporter, and also sends a letter of advice to the effect that a letter of credit has been issued to the American electric motor manufacturer. Such a letter of credit can be either revocable or irrevocable, confirmed or unconfirmed.

When the shipment of electric motors is ready, the American manufacturer draws a sight bill for \$280,000, attaches the documents to it, and presents the whole to the New York correspondent bank which pays the draft and forwards the documents to the London bank for transmittal to the British electric refrigerator manufacturer. Once in possession of the documents, the British refrigerator manufacturer can withdraw the motors from the steamship company, clear the shipment through customs and ship the motors to his factory.

The British refrigerator manufacturer has to pay the bank in London, which issued him the letter of credit, the equivalent in pounds of the \$280,000 draft. If the pound were at par on the day the draft is paid, the transaction will have cost him £100,000. Since the British manufacturer did not know, when he ordered the electric motors, just what the rate of exchange would be on the day the bill was presented for payment, he will have been wise to have purchased forward dollar exchange at the time he signed the order for the electric motors and thereby fixed the rate of exchange for the transaction.

*Some financial effects of the bill.* This United States export transaction, regardless of the means of financing employed, gave rise to a demand from British sources for United States dollars. If the British refrigerator manufacturer purchased the necessary \$280,000 required to close the transaction from a British bank, Britain's holdings of dollars were decreased. On the other hand, if the dollars were purchased from an American bank against pounds, then the United States supply of British pounds was increased. Again, the appropriate balance of payments entries for transactions of this type were outlined in chapters 3 and 4,

and the next chapter indicates the impact of this type of transaction on the rate of exchange.

### Financing Travel and Other Services

An American travelling abroad needs the currency of every country which he plans to visit to meet his expenses. If he knows just how much money he is going to spend in each country, he can arrange through his bank to purchase the foreign currencies before leaving the United States in the required amounts for each nation visited. Or he can purchase the required foreign currencies in each country visited against payment in dollars. When they travel abroad most Americans usually carry dollars, not in bills or coin, which run the risk of loss or of theft, but in traveller's letters of credit or checks purchased before embarking for the first foreign port.

*Traveller's letter of credit* Banks which do foreign exchange business issue traveller's letters of credit, and many other banks which do not do this type of business have correspondent relations with banks which do and can arrange for their purchase. This document is a printed form letter duly signed by a bank officer, which authorizes the holder to draw drafts on the issuing bank up to a given total amount. As each draft is drawn, it is entered on the back of the letter of credit until the total amount has been exhausted.

The traveller is provided with a list of the issuing bank's correspondents who will honor the drafts or bills drawn on it and pay them in the local currency at the going rate of exchange for these drafts. The holder of these letters of credit assumes, of course, the risks attendant upon fluctuations in the rate of exchange. In a separate folder, the traveller's signature is carried on a card duly certified as exact by an officer of the issuing bank. If the letter of credit and signature card are kept in separate places, the danger of forged drafts is reduced and this is one of the protective features of this type of financing.

*Traveller's checks* Since drafts drawn under traveller's letters of credit can only be cashed at one of the issuing bank's branches or official correspondents and only during banking hours, many tourists prefer to use traveller's checks which can be cashed almost anywhere and at any time. They are issued by certain banks and financial agencies such as the American Express Company and are agreements by the issuing bank or company to pay to the order of the person or firm which cashes them. They are usually issued in fixed denominations of \$10, \$20, \$50, \$100 and \$500, and the purchaser signs each check at the time he buys it. In order to be cashed or made negotiable, the checks must be countersigned by the purchaser in the presence of the payee.

and are only valid when the countersignature is that of the purchaser. The payee compares the two signatures and in this way is able to establish the fact that the person who presents the check is the bona fide owner of it. These checks are usually paid in the currency of the country in which they are cashed at the rate applicable to these instruments, and the risk of exchange rate fluctuations falls on the holder of the checks. The cashed or paid checks are payable upon presentation to the offices of the issuing bank or company.

American travellers, whether they use letters of credit or traveller's checks provide a demand for the foreign currency of each country which they visit. The drafts drawn under a letter of credit and the checks either add to the supply of dollars, or dollar holdings, of the countries in which they are cashed or reduce United States holdings of the foreign currencies involved.

*Foreign travellers* Foreign travellers in the United States use similar procedures. They can purchase United States currency before departure with all the risks attendant upon carrying large amounts of cash. They can buy a traveller's letter of credit, denominated in either their own currency or in dollars, or they can purchase traveller's checks in their home currency or dollars.

If they use a letter of credit or traveller's checks drawn in their own currency, they receive dollars at the rate of exchange applicable at the time the draft is drawn or the check cashed. They thus assume the risk of exchange rate fluctuations while enroute and, in addition, hotels and stores (since they usually do not deal in foreign exchange) may be unable or unwilling to cash traveller's checks denominated in a foreign currency. On the other hand, if the foreign traveller purchases the letter of credit or traveller's checks denominated in dollars, the risk of day to day exchange fluctuations is eliminated and the traveller's checks can be much more readily cashed.

If the travellers, bearing letters of credit and traveller's checks denominated in their local currency, came from a large country whose money was well-known and widely traded, they would have little difficulty in cashing them at U S banks. On the other hand, if their country of residence were small and little known they might experience some problems in cashing their instruments, especially at smaller, inland banks. Most foreign travellers in the United States today, use dollar letters of credit and traveller's checks.

Foreign travellers in the United States provide a demand for dollars. Their purchases of dollars, if made abroad, serve to reduce their countries' holdings or supply of dollars. If the instruments are purchased in the United States, our supply of foreign currencies is increased.

*Other service transactions.* Transactions in services—transportation, insurance and reinsurance, contractor's fees, motion picture rentals and royalties, home office expenses, and income on investments, among many others—are usually financed by one of the methods, or a variation of it, sketched in this chapter, and in general they tend to follow the practices of the trade in each case. For these transactions, the bank draft is more widely used than a letter of credit or bill of exchange.

### Financing Unilateral Transfers

*Immigrant remittances.* Immigrants making small payments in cash to family or friends abroad may very well remit by means of a personal check drawn on a United States bank, an international postal money order or by enclosing dollar bills in a letter. Since such a transaction is a unilateral transfer and does not involve the liquidation of a debt due abroad of a fixed sum, the amount of foreign currency realized from the exchange of the United States dollar check, money orders or bills is perhaps not of prime importance, and the "risk" of the exchange in such cases is borne by the recipient. These unilateral transactions do, however, create a demand for the money of the country where the check or dollars are exchanged into the currency of the recipient, and they add to the dollar holdings of that country.

For larger transactions, immigrant residents of this country, foundations, religious, charitable, educational and welfare institutions making unilateral transfers abroad can pay in a variety of ways. One convenient method consists of purchasing and forwarding a bank draft, i.e., a draft drawn by an American bank on one of its branches or correspondents abroad, in the currency of the recipient. In this case, there is a United States demand for the currency of the recipient country, and when the draft is paid the United States holdings of the foreign currencies in question are reduced, or foreign holdings of dollars increased.

*Government unilateral transfers* When the United States government makes a grant to a foreign nation it can utilize several methods of making payment. It frequently establishes a credit in an American bank in favor of the recipient country. The central bank of this country, or some government financial agency, can then draw on these dollar credits until the amount is exhausted. If, under a grant, the purchase of goods were made in the United States, the United States government (or one of its financial agencies) makes payment directly to the American firm in question. Foreign short-term dollar holdings are increased when the credit is established and decreased as American suppliers are paid from these credits.

*Counterpart fund financing* Under the Marshall Plan, most of our

grants (but not our loans) were financed by a novel procedure which can be illustrated by the following example. Assume that the Belgian government obtained approval, under its Marshall Plan requirements, for \$500,000 worth of textile machinery. A Belgian textile manufacturer desired to purchase some of this equipment and obtained approval of his government to buy power looms having a total value of \$100,000 from an American manufacturer. The Belgian mill ordered the looms and the American government paid the American manufacturer of the looms in dollars for the amount of the order.

Under the Marshall Plan method of financing, the Belgian textile mill must pay the Belgian government the equivalent in Belgian francs of the \$100,000 cost of the looms. These Belgian francs, paid by the mill to the Belgian government, were known as "counterpart funds" and, although they belonged to the Belgian government, this government was not free to spend them as it saw fit. In the first place, 5 to 10 per cent of these funds was reserved by the United States to meet the costs of the Marshall Plan Mission to Belgium as well as certain other government expenditures such as expenses of United States officials and members of Congress travelling in Belgium. The remaining 90 to 95 per cent could only be spent by the Belgian government with the approval of the United States, and often a substantial portion was invested in Belgium. The deposit of the 5 to 10 per cent of these counterpart funds, accruing to the credit of the United States in a Belgian bank, increased the United States government supply of a form of short-term capital, usually foreign bank balances.

*Other local currency financing.* Sales of surplus agricultural commodities under Section 402 of the Mutual Security Act and Public Law 480 are sometimes made to foreign governments in need of these commodities against payment in local currency, especially when they do not possess a large supply of dollar exchange. In these sales, the United States becomes the owner of the local currency so acquired and can spend it for a variety of legally authorized purposes.

Under the Marshall Plan type of financing, except for the 5 to 10 per cent of the counterpart funds reserved for the United States government, the counterpart funds do not change national ownership. Under Section 402 of the Mutual Security Act and the Public Law 480 type of financing, United States government holdings or supply of foreign currencies is increased.

*Off-shore purchases.* Often, under foreign grant, aid and military assistance programs, the foreign recipient of the aid makes what are known as "off-shore purchases," that is, the dollars acquired are used to buy goods in some third country. Thus a grant of military aid to Turkey

might be used, in part, by that country to buy uniforms in France. In this case, a part of the dollar credit set aside for Turkey in a United States bank would be used to purchase French francs to pay for the uniforms. Obviously, such a transaction would increase France's holdings of dollars and increase United States demand for French francs.<sup>3</sup>

*Tied loans* Official United States loans made by the Export-Import Bank of Washington are known as "tied loans;" that is, the proceeds of these loans must be used to buy goods in the United States and cannot be employed to purchase goods in third countries. Loans made by some other official United States agencies are not always tied and may be spent where the borrower desires. International financial transactions resulting from these loans and their effects upon the demand for, and supply of, dollars and other currencies depend upon the types of transactions involved and the uses to which the proceeds of these loans are put.

### Financing International Capital Movements

Bills used to finance the export and import of merchandise, since they are frequently accompanied by various documents, are known as "documentary bills." Bills used to carry out financial transactions or capital movements, which are not accompanied by any documents, and any other non-documentary bills are known as "clean bills."

*Portfolio investments abroad.* Let us suppose that an American investor desires to purchase some common stock or bonds of a British firm. He sends his order to a British stockbroker to buy the securities at an indicated price on the London Stock Exchange. The British broker purchases them for a total price of, say, £100,000. The American investor can pay for the stock in one of several ways.

After the purchase of the stock the British broker can draw on the American purchaser at sight, or 30, 60, 90 days after sight or on whatever other terms of payment that have been agreed upon. On the other hand, the transaction can be financed through the use of a letter of

<sup>3</sup> This off-shore purchase can be handled in two ways on the United States balance of payments. When the transaction is consummated, the United States government can debit unilateral transfers and credit the appropriate short-term capital account for the amount of the transaction. On the other hand, this transfer can be shown as an import of merchandise—a debit to the merchandise account—when the uniforms are purchased in France and as a credit to the appropriate short-term capital account when they are paid. When the uniforms are shipped by France to Turkey, the transaction can be treated as a United States export and the merchandise export account can be credited and unilateral transfers debited for the amounts involved. The Department of Commerce employs this second method of posting the transaction to the balance of payments accounts.

credit similar to an American merchandise import from Britain. If the British broker had any doubts about the financial standing of the American purchaser, he would be likely to employ letter of credit financing.

The American securities purchaser might pay for the securities in still another way. When he receives the bill from the British stockbroker for the cost of the securities, he can buy a draft from an American bank, drawn on its branch or correspondent bank in London, for the £100,000 involved in the transaction plus all associated costs.

In any event, the purchase of British securities by an American resident creates an American demand for British pounds and serves either to decrease United States holdings of pounds or to increase British holdings of dollars, depending upon the manner in which the transaction is ultimately settled.

A British purchase of American securities can be similarly financed. In this case, the American broker can draw on the British security purchaser for the total amount of the transaction; the British purchaser can finance it by the use of a letter of credit, or he can pay for it by forwarding a draft drawn by a British bank on its deposits of dollars in an American branch or correspondent bank. Such a purchase creates a British demand for United States dollars and decreases British holdings of dollars or American holdings of British pounds, as the circumstances of settlement determine. Often purchasers of foreign securities protect themselves against fluctuations in the rate of exchange by the sale of forward exchange to be delivered when the foreign security is expected to be sold.

The purchase of securities as outlined above, if it involves the ownership of less than 25 per cent of the voting stock of the corporation, is termed a portfolio investment, in the nomenclature employed by the Department of Commerce. If more than 25 per cent of the stock is owned, the stockholder is deemed to have a managerial interest in the corporation and the investment is termed a direct investment. It should be noted that any form of stock ownership or agreement which gives a United States resident a substantial voice in the management of a foreign concern is termed a direct investment.

*Direct investments* There are many direct investments made by Americans in foreign corporations and by foreign companies and residents in American firms. The methods used in financing these transactions depend upon the type and nature of the investment. To illustrate one form of direct investment made by American business firms abroad, assume that an American automobile manufacturer decides to establish an assembly plant in the United Kingdom. Such an investment might be made for a variety of reasons. automobile parts may pay a lower rate

of tariff duty than assembled cars; savings in transportation might be effectuated, the assembly plant could better serve the European markets and its products could be advertised as British-made.

The assembly plant is incorporated, or established as a limited liability company under British law, which means, as far as the United States is concerned, that the subsidiary is a British "resident." The subsidiary is capitalized, say at £5 million, and most of the stock is subscribed and paid for by the American parent company. Payment for the capital stock can be made in one of several ways. Assume that half of it is paid for in pounds, deposited to the account of the subsidiary in a British bank, and the other half in dollars deposited by the parent corporation to the credit of its subsidiary in a New York bank.

The parent company would have to purchase the pounds sterling on the open market or from a bank, and this transaction would increase the demand for pounds, decrease the United States supply of pounds, if bought here, or if the pounds were purchased from a British bank or dealer, increase England's supply of dollars. The deposit of the dollars in an American bank to the credit of the English assembly plant would increase Britain's holdings of dollars, since title to them would have passed from an American resident to a resident of Britain, the automobile assembly plant.

The subsidiary purchases land from a British resident and contracts with a British builder to construct the plant, both for a stated value in pounds. Both of these transactions, since they took place in England between British residents, were domestic transactions and involved no international financing.

The American parent next ships some of its equipment, machines and tools to the British subsidiary which also orders additional machinery from other American suppliers. These items are paid for by checks drawn by the British subsidiary on its account in New York in dollars. These transactions increase Britain's demand for dollars and, when paid, decrease their supply of dollars. As the American automobile company sends parts to its British subsidiary to be assembled, they are paid for by checks drawn on the New York account with similar international financial effects.

When the New York bank account is drawn down, how does the British subsidiary replenish it? The simplest method it can use is to buy dollars against pounds from a British or American dealer or bank and build up its New York deposit balance by the deposit of the proceeds of these transactions. Its sterling account at its British bank is replenished by the sale of finished automobiles against pounds sterling.

## Financing International Transactions—Other Aspects

International capital transactions include many types of financing which are not associated with the trade in goods and services, unilateral transfers, portfolio and direct investments. For one thing, banks must replenish their deposits abroad of foreign currency when they become drawn down, and dealers must reconstitute their supplies of foreign exchange when they become depleted. They can do this in a number of ways. They can buy bills of exchange denominated in the required foreign moneys; they can create foreign currency deposits in overseas banks by buying currencies against dollars from them; they can borrow foreign money, or they can sell their holdings of foreign or American securities against other currencies.

*Short-term borrowing.* Although borrowing may be done through the usual promissory note procedures, the bill of exchange affords a convenient method of raising money for short periods. A New York bank desirous of borrowing French francs can draw a bill in francs on its French bank or correspondent bank for 30, 60, 90 or 120 days after sight. When the French bank accepts the bill and gives it a date, the bill can be sold on the Paris market for its franc face value less the discount. The New York bank thus has the market value of the draft for its use and need not pay it until maturity.

Bankers and financial dealers are keenly aware of differentials in the market rates of interest. Thus the market rate of interest for a given type of bill or note might be 4 per cent in New York and 5 per cent in Belgium. It would pay individuals and financial institutions which had disposable funds for loans of this type to lend them in Belgium rather than in the United States. In addition, a profit could be realized by borrowing funds in the United States at 4 per cent and lending them in Belgium at 5 per cent. Such a lending transaction could be financed, for short periods of time, by the use of a bill as outlined above, or through the regular promissory note procedure. The differential in the rates of interest must, of course, be sufficiently large to compensate for the risks involved and the costs, and exchange regulations must be sufficiently flexible to permit such types of transactions. In transactions of this type, where he is responsible for the payment of foreign funds at some time in the future, the borrower generally protects himself by the purchase of forward exchange to avoid losses which might arise from exchange rate fluctuations during the life of the transaction. The interest rate differential has to be sufficiently large to compensate for the cost of the forward exchange.

Short-term capital transactions are also employed for speculative

undertakings, to anticipate a rise or fall in the exchange rate, to engage in exchange arbitrage arising from differentials between two or more rates of exchange, as well as to speculate in commodities against variations in prices on the several markets.

*Open accounts and indents.* Some international transactions, where the buyer and seller are well known to each other, are financed by book or open account procedures like many American domestic transactions. Thus the exporter debits the book account of the importer for the value of the merchandise ordered and periodically sends a statement of account to the importer who has agreed to remit at specified periods. Remittance can be made in a variety of ways, often by bank draft.

A specialized import-export procedure is employed by many former British possessions in the Far East and Australasia and is known as the indent. The indent is an order by an importer on an exporter to supply certain goods at stipulated prices and delivery dates. When accepted by the exporter it is a valid contract for the delivery of the goods under the specified conditions. When the goods are shipped by the exporter, they are paid for usually by letter of credit or bill of exchange methods. A form of indent procedure was widely employed by several British colonies during World War II for the purchase of materials procured under Lend-Lease.

*Role of short-term capital accounts.* Where foreign exchange markets are free from controls, they provide flexible methods of financing all types of international transactions. This chapter has sketched a few of the principal methods employed in modern international trade, but it is far from constituting a compendium of the subject. Foreign financing usually is carried out through international checking or deposit accounts recorded in short-term capital accounts, both United States and foreign, which are shown on balances of payments.

When the United States is running a surplus on its balance of payments, its assets, holdings of foreign currencies (balances on its short-term capital accounts) increase and are indicated by debits, foreign holdings—liabilities—of United States dollars or deposits in this country tend to decrease and are also indicated by debits. Deficits on its balance of payments have the opposite effects and are characterized by decreases in United States holdings—assets—of foreign currencies or its balances abroad and by increases in foreign holdings—liabilities—of dollars or balances in United States banks. Both are shown by credits.

In connection with the following chapter on rates of exchange, it is important to bear in mind that the financing of international transactions involves increases or decreases in the demand for, and supply of, foreign currencies and U. S. dollars. Generally speaking, United States payments

abroad mean an increase in its demand for foreign currencies, decreased supplies of these currencies, and an increased foreign supply of dollars. Conversely, United States receipts from abroad mean an increased foreign demand for dollars, increases in its supply of foreign currencies, and a decreased foreign supply of dollars. Fluctuations of demand and supply in the market for currencies is one of the principal determinants of the movement of exchange rates. This subject is explored in the next chapter.

## QUESTIONS AND PROBLEMS

- 1 If a Brazilian importer offers to pay in cruzeiros at the current rate of exchange, ninety days after sight, for U S exports to him and the offer is accepted, what steps should the American exporter take to protect himself against exchange rate fluctuations?
- 2 Explain the popularity of the letter of credit as a means of financing exports and imports of merchandise
- 3 When an American exporter sells goods abroad, he is subject to certain risks. Explain what these risks are and show how some of them can be reduced by appropriate methods of financing
- 4 Explain why some large American banks maintain correspondents and branches abroad
- 5 If funds amounting to \$100,000 are invested in United States industrial bonds paying 4 per cent and an opportunity arises to invest this sum in the bonds of a French industrial enterprise paying 5½ per cent, how could the investor go about liquidating his United States investment, buying and paying for these French bonds? What risks are involved? How can the investor hedge against some of them?
- 6 In 1958, when the United States ran a substantial deficit on its balance of payments U S exporters were advised to sell more merchandise abroad. If they had been successful in increasing exports of goods, what would have been the effects upon U S holdings of foreign currencies and foreign holdings of U S currency? Explain the mechanism by which these holdings would have been increased or decreased
- 7 An Italian importer desires to buy \$50,000 worth of U S products. Inquiry indicates that he is considered a good credit risk but "slow pay." To introduce these products in Italy, the U S exporter desires to sell him the goods. How should the exporter arrange for the importer to pay for the transaction?
- 8 List reasons why the United States is willing to accept local currency, instead of dollars for its official exports of certain agricultural products. To what uses can the United States government put these local currency funds?
- 9 Under what circumstances would goods ordinarily be exported to a Japanese importer on open, or book, account?
- 10 An American tourist in Paris desires to buy some antique furniture in that city, but the purchase price exceeds the amount of money which he is

carrying in traveller's checks. The traveller has sufficient funds in his local bank in the United States to pay for the purchase, but his local bank has no correspondents in France. The French dealer states that he will take either French francs or dollars but will not accept a personal check. In what ways can the tourist arrange to pay for the antiques?

For bibliography see end of chapter 9.

## Financing International Transactions: The Rate of Exchange

"In speaking of the exchange and the comparative value of money in different countries, we must not in the least refer to the value of money estimated in commodities, in either country. The exchange is never ascertained by estimating the comparative value of money in corn, cloth, or any commodity whatever, but by estimating the value of the currency of one country, in the currency of another."<sup>1</sup>

In these incisive words, David Ricardo described the basis of exchange rate determination. The rate of exchange is the value, as Ricardo says, of the currency of one country in terms of that of another. This definition immediately suggests two inferences. There are as many rates of exchange for a nation's currency as there are countries which trade with it in their own currency, and the rate of exchange is a price—the price of one currency in terms of another.

Thus we have a dollar-pound, franc-dollar, cruzeiro-dollar, peseta-dollar, lira-dollar and other rates of exchange. The rate of exchange is also a price. For Americans it is the price of dollars in terms of pounds, francs, cruzeiros, pesetas, liras or any other currency, or the prices of these currencies in terms of dollars, depending upon the way the exchange is quoted. In a capitalist economy, price is of great importance because it is one of the basic determinants of the way resources are allocated and of the manner in which the economy operates. Some prices are of more importance than others, and the rate of exchange is a fundamental price for all economies which trade overseas.

The price of all merchandise and services overseas is the resultant of two factors, the price of the item itself and the rate of exchange.

<sup>1</sup> Ricardo, David, *Principles of Political Economy and Taxation*. Edited, with Introductory Essay, Notes and Appendices by E.C.K. Gomer. London, 1891, p. 128.

Thus, if a given type of British tweed sells for one pound per yard, it would cost an American importer \$2.80 a yard if the rate of exchange were \$2.80, \$2.82 if the rate were \$2.82, \$2.78 if the rate of exchange were \$2.78. As the rate of exchange of a given country rises, its exports become more expensive and its imports cheaper. As it falls, its exports become cheaper and its imports dearer. The level and the movement of rates of exchange, therefore, directly affect the costs of all exports and imports of goods and services, unilateral transfers and capital.

### Foreign Exchange Under the Gold Standard

Present exchange systems take their roots in the gold coin standards and are modifications or developments of these older systems. For this reason, although the gold coin standard no longer prevails, it will be helpful to start the discussion of exchange rates by seeing how they were determined under this standard. Also, in this way, the subject can be placed into its historical perspective.

*The mint par of exchange* Pure gold is a commodity, homogeneous in all times and places. The standard exchange rate under the gold coin standard is found by comparing the amount of fine gold in the monetary unit of one country with that of another. Thus if the monetary unit of country A contains five times as much fine gold as that of country B, the standard rate of exchange is 5 units of country B's money equal one unit of country A's, or one unit of country B's currency is equal to 0.20 units of country A's. This standard rate is called the "mint par of exchange."

Before World War I England and the United States were each on a form of the gold coin standard. The former English gold pound or sovereign (so-called because it had the image of a British sovereign on one side) contained 123.274 grains of gold, 11/12, or 22 carat, fine which was equal to 113.003 grains of fine, or pure, gold. The former United States gold dollar contained 25.8 grains of gold, 9/10 fine, or 23.22 grains of fine gold. Since the pound contained 4.8665+ times as much fine gold as the dollar, the par of exchange between the pound and the dollar was quoted as one pound equals \$4.8665+. The par and the rate of pound-dollar exchange are quoted as one pound equals so many dollars. It would be possible to quote this par of exchange by saying that one dollar equals 0.20556 pounds, but custom has established the practice the other way around.

The pre-World War I pars of exchange between France, Belgium and Switzerland and the United States were, francs 5.1625 equaled one dollar or one French, Belgian or Swiss franc equaled 19.35 United States cents. In Germany, the reichsmark par of exchange was generally quoted in terms of the dollar value of four reichsmarks or four reichs-

marks equaled 95.25 United States cents, although the rate for a single mark, 23.81 United States cents, was sometimes used.

The actual or *market rate of exchange* which prevailed between any two countries on the gold standard did not always correspond exactly to the par. The rate of exchange differs from the par in that the rate is determined, not by relative amounts of gold in the respective monetary units, but by the demand for, and the supply of, means of payment, i. e. bills, bank drafts and sometimes the currency itself. Shifts in the relative demand and supply for means of payment brought the actual rate of exchange to fluctuate above and below par. The rate between two countries could change several times a day or even several times an hour in periods of active trading.

*The gold points.* The rate of exchange could never deviate very much from the par of exchange because under the old gold coin standards people could obtain gold from a central or commercial bank on demand in exchange for any other type of national currency. If the rate of dollar-pound exchange rose by an amount which exceeded the cost of shipping gold, an American importer from England could obtain gold from his bank or from the Treasury and ship it to England to satisfy his debt instead of paying by draft or bill, and it would be cheaper to do so. Conversely, if the rate of sterling exchange fell below par by an amount exceeding the cost of shipping gold, an American who had pounds due him from a British resident could ask the resident to ship him gold which would net him more after paying the shipping costs, than the sale of a bill or draft.

At the time of the gold coin standard the cost of shipping gold between England and the United States amounted to about two cents per pound sterling. This cost included the ocean freight of the shipment, insurance, packing, loss of interest while the shipment was on the water and loss by abrasion.<sup>2</sup> These costs were not fixed, of course, but varied from time to time and from country to country. The dollar-pound gold export point was about \$4.87 plus two cents, and an exporter would not pay any more than this for a bill in draft in pounds because he could ship gold at that price. The holder of pounds would not sell them for any less than \$4.87 minus two cents, because he could purchase a gold sovereign in England and bring it back to the United States for a cost

<sup>2</sup> In international trade in gold, the shipper is only given credit for the actual weight of the fine gold received regardless of the official seals or signs on the coin or bullion certifying its value or weight. No matter how carefully packed, gold loses some weight by abrasion during shipment. Thus if a ten dollar gold piece which weighed at the mint 258 grains, 9/10 fine, weighed but 257 grains when it arrived, the shipper would be given credit for 257 grains of gold 9/10 fine.

of two cents. This gold import point constituted an effective floor below which the pound-dollar rate of exchange could not fall. Similar gold points existed for the exchange of all countries on a gold standard at that time.

*The price-specie-flow mechanism.* When the rate of pound-dollar exchange reached the United States gold import point, gold tended to flow out of England into the United States and when it fell to the gold export point, it tended to flow back into England from the United States. What, one may ask, was to prevent a severe and persistent British balance of payments deficit from draining England of all her gold? And what would prevent a prolonged British balance of payments surplus from pouring gold into England at the expense of her trading partners? The answer to these questions was provided in 1752 by the Scottish philosopher, David Hume, and the term, "price-specie-flow mechanism" has been given to Hume's explanation.<sup>3</sup>

The following example illustrates the operation of this mechanism. Suppose country A trades largely with country B. A consistently has a surplus on its balance of payments with B. The currency of A rises to the gold importing point, B's currency drops to the gold exporting point. Gold flows into A from B. As a result, there is more gold in circulation and in bank reserves in A and less in B. If all resources were employed and output of goods remained constant in A, the influx of gold and the increase in bank credit would cause prices to rise in that country. In B (again assuming constant resource utilization and goods output) the outflow of gold would cause a decline in money in circulation and bank credit, and prices would fall.

Exporters in A now find B a poor customer for A's high-priced goods and services. But A, with its high prices, is now a good market for imports from B where prices are lower. A no longer has a balance of payments surplus with B, and B no longer has a deficit with A. Equilibrium has been restored, at least temporarily, in the balances of payments of both countries. Should B build up a balance of payments surplus vis-à-vis A, this same price-specie-flow mechanism will again operate to restore equilibrium. This mechanism, which is based upon a highly simplified concept of the quantity theory of money, is held to restore automatically balance of payments equilibria.

*Automatic distribution of the gold supply and the international level of prices.* David Ricardo, the author cited in the opening paragraph of this chapter, developed two theories from the reasoning underlying this

<sup>3</sup> Hume, David, "Of the Balance of Trade," in his *Political Discourses* (1752), as quoted in Monroe, A. E., *Early Economic Thought*, Cambridge, Mass., 1924, p. 325.

mechanism.<sup>4</sup> One of his theories is called the automatic distribution of the world's gold supply and the other the international level of prices.

Gold flowing in and out of nations, in response to balance of payments disequilibria and price movements, tends to distribute itself automatically among the nations of the world. No government intervention, no special regulations or controls are needed to guarantee this distribution. Each nation obtains the gold it needs, or rather the gold which it justifies, according to its price level and rate of exchange. There is also a tendency for prices in all nations, through the operation of this mechanism, to seek uniform levels and thus create a world level of prices. Prices move up and down in each nation in accordance with the operation of the mechanism, until they tend toward uniformity in all places.

Like many of the theories of the Classical School, the price-specie-flow mechanism, the automatic distribution of the world's gold supply and the tendency toward an international level of prices present a simplified and somewhat unrealistic picture of man's economic life and the way it functions. In practice, gold inflows may fail to enter into circulation, and gold in the reserves of central banks is not always followed by an expansion in bank credit. Its inflationary impact might be checked by increasing reserve requirements, discount rates, qualitative controls. And, as already noted, countries have not always played the gold standard game.

In addition, all prices are not subject to international leveling, they must be traded internationally for this to happen. The price of hair cuts in Paris may be low, while those in New York may be high but, since they are not internationally traded, they will not attain an international level. Further, the prices of goods which are not uniform cannot well be leveled. A Parisian *haute couture* dress, made to order and individually styled, might cost \$1295 in an exclusive Parisian *atelier*, while a lady may be able to purchase a presentable dress for \$12.95 at one of the chain store dress shops in the United States. The prices of these two dresses will not be internationally equalized, because they are not the same thing.

Man-made controls and regulations also serve to hold these tendencies in check. Controls over exports, imports and foreign exchange are used to prevent goods, services and capital from moving freely in international trade. Thus a balance of payments with a tendency to get out of equilibrium may be artificially balanced by the use of controls and gold flows, as a consequence, can be checked.

Nevertheless, although these theories have been modified and are

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<sup>4</sup> Ricardo, *Op. cit.*, pp. 117 ff.

of limited application, they are still useful. They indicate tendencies in our international economy, not always active, but always latent. They are also useful tools of economic analysis and are frequently helpful in resolving problems of economic policy and for forecasting the possible results of different international actions.

*Determination of the rate of exchange.* Under the gold standard the rate of exchange is the price of one currency in terms of another. This rate fluctuates around the mint par and is limited in its movements by the gold points. It is a somewhat special type of price. The actual rate is determined by demand and supply factors for the currency in question where trading in foreign exchange is free of restrictions. In the United States for example demand for the English pound sterling comes from those who have payments to make in pounds. When Americans purchase pounds to make these payments, they satisfy demand and either reduce our supply of pounds (if purchased in the United States) or increase England's supply of dollars (if the pounds were bought in England).

To illustrate the determination of the rate of exchange on free exchange markets at any given moment assume that United States demand and supply for pounds stood as indicated in Table 9.1.

TABLE 9.1  
UNITED STATES DEMAND AND SUPPLY—ENGLISH POUNDS

Rate of Exchange	Number of Pounds Demanded	Number of Pounds Supplied
4.88	500	1500
4.87	750	1250
4.86	1000	1000
4.85	1250	750
4.84	1500	500

Using the demand and supply schedules from Table 9.1, Chart IX.1 indicates how the equilibrium rate of exchange is determined. Under the assumed demand and supply schedules, the rate would be \$4.86, and this rate would clear the market. In active trading during any business day the rate may change from time to time and different rates succeed one another.

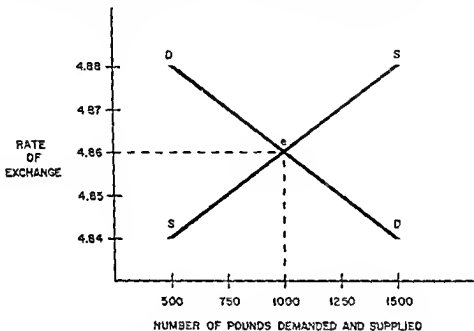
### Elements Involved in Exchange Rate Determination

The rate of exchange is determined by the forces of demand and supply on free exchange markets as is the case with other competitively established prices. There are, however, certain particular features of the demand and supply for foreign exchange, the markets on which it is traded and the mechanism by which the rates are set.

### CHART IX.1

#### DETERMINATION OF THE RATE OF EXCHANGE ON A FREE MARKET

Line DD represents demand for pounds, line SS, supply. At intersection point *e* there is a partial equilibrium and amounts demanded and supplied are equal. The rate of exchange for pounds is therefore \$4.86, and 1000 pounds will exchange at this price. At a higher price, e.g. \$4.87, buyers demand fewer pounds (750) than suppliers offer (1250). Bidding by buyers and sellers will force this price down. At a lower price, e.g. \$4.85, buyers demand more pounds (1250) than suppliers offer (750). Bidding will force this price up to the point (*e*) where demand and supply are equal.



*Derived and composite demand and supply.* The demand and supply for foreign exchange are derived except where it is bought and sold for itself as with speculation (where it is used as a source of expected profit) and with banks and dealers who buy it from, and sell it to, others. The demand schedule for it, is derived from those of the goods which are purchased with it. An American importer of British tweed desires sterling exchange to pay for these purchases and his demand for this exchange is derived from his demand for tweed. The supply is likewise derived from the sale of goods to foreign purchasers. If a British importer buys some fractional horsepower motors from a United States exporter and buys dollars to pay for the transaction, the ensuing supply of pounds is derived from the proceeds of the sale of the motors. The demand and supply of any foreign currency thus takes

on the characteristics of those of the goods which it was used to purchase and sell.

It is relatively easy to determine the nature of the demand and supply for foreign exchange for countries having but few exports and imports. In the case of a nation like the United States, with a wide variety of international transactions, foreign exchange demand and supply are an aggregate of many items of diverse characteristics and are difficult to estimate.

The demand and supply for foreign exchange are also *composite* because they are made up of those for many different products and services. Exporters of a wide variety of goods give rise to a supply of foreign exchange which is a composite of many sources. Importers of many different kinds of articles demand foreign exchange and demand is thus a composite of that for a wide variety of goods.

*Elasticity of demand for foreign exchange.* Buyers of foreign exchange are responsive to movements in its rate. If the rate increases or decreases, they will alter the number of units of foreign exchange demanded. Economists employ the concept *elasticity* to describe the nature of these demand conditions. The elasticity of demand for foreign exchange reflects the responsiveness of buyers to a change in its price (the rate of exchange).<sup>5</sup> If purchasers are highly responsive to a given change in price, demand is said to be *elastic* over this price range. If they are only slightly responsive, demand is *inelastic*.

The degree to which buyers are influenced by a movement in price is reflected in the demand function and can be classified under one of three possibilities: *elastic demand*, *unitary elasticity* and *inelastic demand*. One method of determining the type of elasticity is by comparing the percentage change in quantity demanded with the percentage change in price. Specifically:

- a) if the percentage change in quantity demanded *exceeds* the percentage change in price, demand is *elastic*;
- b) if the percentage change in quantity demanded *equals* the percentage change in price, *unitary elasticity* exists; and
- c) if the percentage change in quantity demanded is *less than* the percentage change in price, demand is *inelastic*.<sup>6</sup>

<sup>5</sup> It should be noted that elasticity of demand measures the *slope of a given demand function*. It should not be confused with changes in demand where the entire demand function shifts.

<sup>6</sup> A similar way of determining elasticity is with the formula

$$\text{Elasticity of demand} = \frac{\text{Percentage change in quantity demanded}}{\text{Percentage change in price}}$$

If the numerical value for elasticity exceeds one, demand is *elastic*, if it equals one, demand elasticity is *unitary* and if it is less than one, demand is *inelastic*.

These concepts may be made more meaningful by the use of an example. Assume that the rate of exchange with Great Britain is \$2.80, and at this rate buyers purchase £1,000. A 10 per cent decrease in the price of sterling occurs and the rate declines to \$2.52. The extent to which domestic buyers respond to this price decline determines the elasticity of their demand.

a) If the number of pounds demanded at the new rate is 1,200, demand is elastic over this price range because the quantity demanded has increased by 20 per cent while price changed only 10 per cent;

b) If the quantity demanded also increased by 10 per cent (to 1,100), the elasticity is unitary;

c) If the quantity demanded increased by only 5 per cent (to 1,050) the relative change in quantity demanded is less than that of price and the demand is inelastic.

The elasticity of demand for foreign exchange can also be determined by noting the amount of payments which accrued as a result of a change in the rate of exchange. If demand is elastic, the payments are *inversely* related to the change in the rate of exchange. That is, if the rate of exchange declines, total payments increase, if the rate increases, they decrease. If unitary elasticity of demand prevails, the payments will not change regardless of movements in the rate of exchange. If demand is inelastic, payments will be *directly* related to the rate of exchange; if the rate increases, they increase, if the rate decreases, payments also decrease.

*Elasticity of market supply of foreign exchange* The elasticity of the supply of foreign exchange is closely related to the time period involved. The market supply of foreign exchange represents that on hand or available for immediate sale by exchange dealers. The elasticity of supply of foreign exchange measures the responsiveness of sellers to changes in the rate of exchange. If sellers are highly responsive to these changes, supply is elastic over the relevant range. Supply is inelastic if the amount offered is not greatly affected by a movement in the rate of exchange.<sup>7</sup>

The type of elasticity of supply can be determined by comparing the relative change in amounts supplied with the relative change in price. Specifically,

a) if the percentage change in quantity supplied *exceeds* the percentage change in price, supply is *elastic*,

<sup>7</sup> Unlike elasticity of demand, elasticity of supply cannot be determined by comparing total payments with the change in price because total payments and the rate of exchange are directly related in most instances.

b) if the percentage change in quantity supplied *equals* the percentage change in price, *unitary* elasticity exists; and

c) if the percentage change in quantity supplied is *less than* the percentage change in price, supply is *inelastic*.

Assume, for example, that the United Kingdom rate of exchange is \$2.80 and at this rate exchange dealers are willing to sell £1,000. If there is a 10 per cent increase in the dollar price of pounds the rate will be \$3.08.

a) When the quantity of foreign exchange also increases by 10 per cent (to £1,100), the supply elasticity is unitary because the relative change in quantity offered equals the relative change in price.

b) If dealers offered more than 1,100 units, supply would be elastic because the relative change in quantity supplied exceeds the relative change in price.

c) Supply would be inelastic where dealers offered any amount less than 1,100 units at the new rate. In this case, the percentage change in quantity available for sale would be less than the percentage change in prices.

*Various rates of exchange* There is not one, but rather there are several rates for each country at each moment. This arises from the foreign exchange market practices of providing a "spot" rate for cable transfers and of deducting from this rate the interest or discount applicable to bills having a certain period of time to run. If the spot rate on pounds were \$2.80, and the rate of interest for this type of bill 6 per cent per annum, a thirty-day bill rate could be quoted as \$2.80 minus one-half of one per cent (representing thirty days interest at 6 per cent) or \$2.786. At the same rate of interest the sixty-day bill rate would be \$2.772 and the ninety-day bill rate \$2.758. Under this practice, the higher the rate of interest or discount, the lower the time, or "long," bill's price or rate of exchange.

In the case of forward exchange (where exchange is purchased or sold for future delivery) the rate might be lower or higher by the amount the bank or dealer subtracts or adds to the spot rate. This amount is determined by interest rates, the premium for the risk involved, the fee for the service and the demand and supply of exchange for future delivery. These forward rates are determined under competitive conditions by the banks and dealers offering this service.

The rate of interest or discount applied to a bill of exchange depends upon the interest rate level and structure of the country or money market where the transaction takes place, and it varies over time with the movement of other rates. There is no single rate of interest applied to bills of exchange. The financial standing and reputation of the drawer,

acceptor and endorser of the bill are of importance. The higher their financial standing, the lower the rate of discount applied. This partially accounts for the wide use of the letter of credit which carries a bank's acceptance and is therefore discountable at a relatively low rate.

**Arbitrage and cross rates** On free exchange markets there is a relationship among the rates of all countries. This relationship, known as *cross rates*, is maintained by *arbitrage* transactions. The par of the Belgian franc is two United States cents, that of the Mexican peso, eight cents and the Belgian franc-Mexican peso par is one Mexican peso equals four Belgian francs. Using these pars, when an American buys Belgian francs with \$1000, he obtains 50,000 of them. If he used these Belgian francs to buy Mexican pesos he would get 12,500 pesos. Now were he to exchange these 12,500 pesos for dollars, he would obtain \$1000 for them, the exact amount which he started with, neglecting the costs of the transactions. These pars represent *orderly cross rates* and there would be no profit in buying the currency of any one country mentioned with that of another and selling it in the third market.

Assume that the Belgian franc-Mexican peso rate changed and that the peso is worth now five Belgian francs while the other rates remain the same. An American *arbitragist*, or a person who buys foreign exchange in one center hoping to sell it at a profit in another, could buy 12,500 Mexican pesos with \$1000. With these pesos he could purchase 62,500 Belgian francs and with these francs acquire \$1,250. He would have made \$250 by these transactions, leaving out of account the costs of making them. This profit was possible because the rates of exchange were disorderly. These *disorderly cross rates* would not last for long because arbitragists would buy Mexican pesos and use them to purchase Belgian francs. This increase in the demand for the Belgian francs in terms of Mexican pesos, would force the Mexican peso-Belgian franc exchange rate back into line and the rates would become orderly again. The transactions sketched above are known as *three point arbitrage*, because three financial centers are involved.

*Two point arbitrage* keeps the rates of exchange between any two financial centers in line. Assume that the pound was selling for \$2.50 in New York and \$2.85 in London. An American arbitragist could buy £1000 in New York for \$2,800 and sell them in London for \$2,850, making \$50 on the transaction, exclusive of the costs. These disorderly rates would not last very long, for they would be driven back into line by the purchases and sales of the arbitragists.

**The foreign exchange market.** Unlike stock and some commodity exchanges a foreign exchange market is not an organized market or institution with a fixed trading place, membership and written rules govern-

ing the conduct of members trading on it. Most of the trading is done in the financial, port or foreign trade cities of the world where banks, dealers and brokers deal in foreign exchange and keep in touch with one another and with centers located elsewhere throughout the world. Where free trading in foreign exchange is permitted the markets are highly competitive and one can buy or sell almost any kind of foreign exchange and finance virtually any type of international transaction.

There is no single rate of exchange at any given moment because the rates offered by different banks and dealers may vary by small amounts. The shrewd foreign trader "shops around" before making his purchases and sales. Dealing in foreign exchange is governed by the laws of the place where the market is located and by a body of unwritten customary practices and standards which all are obliged to follow if they desire to continue to deal on the market.

### Foreign Exchange Under Inconvertible Paper Money

The rates of exchange for a selected group of countries using inconvertible paper money which prevailed on January 11, 1962 are shown on Table 9.2.

*Floating rates of exchange* From the point of view of exchange rates, there are two systems of inconvertible money. Under one system, that of freely floating rates, no par of exchange is fixed or a former fixed par no longer applies because so much paper money has been issued that the old par no longer has any relevance and the government makes no effort to enforce it. The free or floating rate is allowed to seek its own level. There have been many instances of such inconvertible paper money. One of the most striking examples was the German mark which became inconvertible during World War I and which was issued in such large quantities that by 1923 the mark had declined from a gold par of 23 81 cents to a paper mark value of about one trillion marks to the dollar. Another type, the fixed rate of exchange, is discussed in a subsequent section.

*The purchasing power parity theory* One theory which seeks to explain exchange rate determination where it is allowed to seek its own level is known as the purchasing power parity theory. It was probably first stated by Henry Thornton in 1802, later made a part of the theory of the Classical School by David Ricardo, and restated in modern terms by Gustav Cassel in 1916.<sup>1</sup> This theory has two forms: the absolute and comparative form.

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TABLE 9.2

## SELECTED FOREIGN EXCHANGE RATES

(Selling prices for bank transfers in the U. S. for payment abroad.)

(In dollars)

Canada (Dollar)	.9570
England (Pound)	2.8100
30-day futures	2.8035
90-day futures	2.7916
Switch or security	2.8099
Australia (Pound)	2.2480
New Zealand (Pound)	2.8000
South Africa (Rand)	1.4069
Austria (Schilling)	.0389
Belgium (Franc)	.020095
Denmark (Krone)	.1453¾
France (Franc)	.2041¼
Holland (Guilder)	.2777
Italy (Lira)	.001615
Norway (Krone)	.1403½
Portugal (Escudo)	.0352
Sweden (Krona)	.1935½
Switzerland (Franc)	.2316¾
West Germany (Deutsche mark)	.2504¾
LATIN AMERICA.	
Argentina ("Free" Peso)	.0121
Brazil ("Free" Cruzeiro)	.00328
Chile (Escudo)	(2)
Colombia ("Free" Peso)	.1155
Mexico (Peso)	.0802
Peru (Sol)	.0375
Uruguay ("Free" Peso)	.0920
Venezuela ("Free" Bolivar)	.2190
NEAR EAST.	
Iraq (Dinar)	2.82
Lebanon (Pound)	.3335
FAR EAST	
India (Rupee)	.2107½
Pakistan (Rupee)	.2111½
Hong Kong (H K Dollar)	1762

Source: *Wall Street Journal*, January 11, 1982

Under the absolute purchasing power parity theory, the rate of exchange is held to establish itself at a point which will equalize the price levels between any two countries. Thus, if prices in country A and B were both at 100 during the base period and a few years later under the pressure of severe inflation they had risen to 200 in country A, while they remained at 100 in B, A's currency in terms of B's would only be worth half as much as it was during the base period. If the rate of

exchange between the two countries during the base period had been two units of A's currency equaled one unit of B's, the rate would have dropped to four units of A's currency equal one of B's. The following formula, among others, is sometimes used in calculating these absolute purchasing power rates of exchange:<sup>9</sup>

$$\frac{\text{Index number of wholesale prices in one country}}{\text{Index number of wholesale prices in another country}} \times \frac{\text{Rate of exchange in the base year between the two countries}}{1} = \text{Purchasing power parity rate}$$

Applying this formula to the case cited in the previous paragraph, we get the following equations

#### BASE PERIOD

$$\frac{\begin{array}{l} \text{Wholesale prices in} \\ \text{country A} \\ 100 \end{array}}{100} \times \frac{\begin{array}{l} \text{Rate of exchange} \\ \text{base year} \\ \$2.00 \end{array}}{1} = \begin{array}{l} \text{Purchasing} \\ \text{power parity} \\ \text{rate} \\ \$2.00 \end{array}$$

Wholesale prices in country B

#### AFTER INFLATION

$$\frac{\begin{array}{l} \text{Wholesale prices in} \\ \text{country A} \\ 200 \end{array}}{100} \times \frac{\begin{array}{l} \text{Rate of exchange} \\ \text{base year} \\ \$2.00 \end{array}}{1} = \begin{array}{l} \text{Purchasing} \\ \text{power parity} \\ \text{rate} \\ \$4.00 \end{array}$$

Wholesale prices in country B

This theory is open to certain objections. In the first place, a nation's *international economic relations consist of much more than trade in commodities*, and this theory only equalizes the prices of commodities. Too, the prices equalized must apply to goods which are standard and comparable between the countries. Many goods of widely varying standards are traded internationally and their prices are not equalized because their precise counterpart in a foreign nation does not exist. A number of empirical studies have indicated that as between certain countries for certain specified periods the theory did not apply in the light of the available evidence.<sup>10</sup>

Another objection to this theory has been advanced by the French

<sup>9</sup> In this illustrative example wholesale price indices have been used, but other indices such as the prices of exports, imports, special groups of goods, or some combination of them, could be utilized if more appropriate.

<sup>10</sup> Cf., Wasserman, Max J., "The Compression of French Wholesale Prices During Inflation, 1919-1926." *The American Economic Review*, March, 1936, pp. 62-73

economist, Albert Aftalion.<sup>11</sup> Aftalion noticed that the sequence, increased money in circulation, rising prices and falling exchange rates tended usually to prevail. At certain times, however, notably in certain European countries between 1921 and 1924, the sequence appeared to be reversed with, first, exchange rates falling followed next by rising prices and then by increasing amounts of money in circulation. He felt that situations such as this discredited the purchasing power parity theory.

Objections such as these have led partisans of the theory to state it in a more acceptable form—the comparative form. Under this statement, the theory affirms a general tendency rather than a rigorous method of determining exchange rates. It asserts that where prices rise in one country relative to others, there is a tendency for the rate of exchange to fall, and where prices fall, for the rate to increase. Stated in this way, there is validity to the theory for this tendency has been noted on many occasions.

The purchasing power parity rate is a *relative rate*, relative in both time and space. It is relative in time to a base rate and reflects the changes which have occurred in the value of a currency at a later as compared with an earlier period. This rate also shows the changes in the value of the currency of one country in terms of that of another and is therefore relative in space.

Purchasing power parity rates may either be established on free and competitive markets in a manner similar to that illustrated on Table 91 and Chart IX 1, or the purchasing power parity principle may be used by governments to establish fixed official pars of exchange as described later in this chapter. On free markets, the actual rate determined by the play of demand and supply tends to correspond to the purchasing power parity rate, with the exceptions already noted. Free market rates of exchange reflect the composite character of the commodities which underlie demand and supply for exchange and demand and supply curves take their shape from the relative elasticities of these two factors.

*Fixed pars of exchange* Under the system of fixed pars, a rate is determined by the government and enforced by pegging operations, by some form of exchange control, or by a combination of the two. The Articles of Agreement of the International Monetary Fund, it should be noted, require all members to maintain fixed rates of exchange.

*Pegged rates of exchange* Under the pegging operation, the government fixes an official par of exchange and attempts to enforce it by having its central bank or a type of exchange stabilization fund enter the

<sup>11</sup> Aftalion, Albert, *Monnaie, Prix et Change* Paris Recueil Sirey, 1927. Especially pp 9-96 and 250-349.

market and buy its currency when the market rate falls below a designated point and sell it when the rate rises above the stipulated high. The rate of exchange is thus government supported. If the official par overvalues the currency and there is a consistent tendency for the market rate to fall, these pegging operations can prove quite expensive, because the support of the rate may entail heavy purchases of a nation's foreign exchange and a reduction of its reserves. Conversely, where the par undervalues the currency (which is seldom the case) the government is constantly selling its currency against foreign exchange and its reserve holdings of foreign currency increase.

During World War I France, aided by credits from the United States, pegged the franc at between six and seven francs to the dollar to maintain a stable external currency while fighting the war. Pegging was abandoned after the war and the rate was allowed to float freely. The franc steadily declined and reached a rate of about forty to the dollar by 1927.

In September 1949 the British government devalued the pound from \$4 03 to \$2.80 and established a new par at the latter price. Whenever the rate declines and approaches \$2.78, the Bank of England intervenes with funds of the Exchange Equalization Account and supports the pound by purchasing it on the market. When the rate rises and approaches \$2.82, the Bank of England sells the dollar exchange held by this Account in an effort to reduce the rate.<sup>12</sup> Under this procedure the rates of \$2.78 and \$2.82 operate as a set of limiting points to exchange rate fluctuations. They are reminiscent of the functions of the gold points under the gold standard. It should be noted that for many years after World War II England relied upon exchange controls, among other things, in maintaining a fixed rate of exchange.

*Exchange controls* The expense and difficulties associated with pegged exchange rates was one factor which led some governments to abandon this method in favor of exchange controls. In addition, exchange controls enable a nation to regulate the movement of all the items on its balance of payments whereas export and import controls permit a country to supervise the import and export of goods and services, but not necessarily of unilateral transfers and capital.

Under exchange controls the free market in foreign exchange is abolished and a monopoly of foreign exchange trading is granted to the cen-

<sup>12</sup> The Exchange Equalization Account was established in 1932, shortly after England abandoned the gold standard, to separate the foreign exchange international reserves from the currency reserves of the Bank of England. At that time the British government did not feel that foreign exchange constituted a suitable reserve for its central bank because where it is so used bank currency and credit must rely too heavily upon balance of payments situations.

tral bank or some other official government financial institution. This system requires all exporters of goods and services and all recipients of foreign exchange to turn over their foreign exchange receipts to the central bank and accept local currency for it at the bank's official and controlled buying rate.

On the other hand, those who require foreign exchange for their imports of goods and services or for any international payment, must buy it from the bank at the official selling rate in exchange for local currency. With the official par of exchange as the center, the bank's buying rate is generally a few points lower and its selling rate a few points higher. The differential between the buying and selling rates allows the bank a small margin to cover its costs and may give it a profit.

Exchange control, by giving a monopoly of exchange dealing to the central bank, constitutes an effective and inexpensive method of maintaining an official rate of exchange at or near parity. It has been widely employed. It is often used in conjunction with import controls where imports are licensed and licenses to import are only granted for what the government considers essential goods and services. By limiting the demands for foreign currency the pressure on the rate of exchange can be substantially relieved and the maintenance of the official par facilitated.

*Overvalued and undervalued rates of exchange.* Theoretically at least a government should fix its par of exchange at an equilibrium or purchasing power parity rate, but this is not always done. Governments may purposely use rates which undervalue or overvalue the currency. The temptation is often great to use the rate of exchange to attain national objectives such as facilitating exports and holding imports in check, facilitating imports and holding exports in check or building up reserves of foreign exchange.

During the Great Depression of the thirties a period of competitive exchange rate devaluations ensued. Various governments set rates which undervalued their currency in order to facilitate their exports. In 1934 the United States government devalued the dollar in an effort to promote its exports. At that time currency devaluation was regarded by some students of the problem as a method of "exporting unemployment." During World War II and for several years after, some belligerents and neutrals maintained overvalued rates which tended to hold exports in check and to facilitate imports. Overvalued rates were used at that time because the nations which used them had but little to export and were sorely in need of imports. Today the pars of exchange of all member nations of the International Monetary Fund are established in consultation with the Fund and with its agreement. Deviations from these official pars are only permitted under the Fund Articles of Agreement in certain specified circum-

TABLE 9.3 (Continued)

## PAR VALUES OF SELECTED METROPOLITAN CURRENCIES

As of June 30, 1961

Member	Currency	Par Values In Terms of Gold	Par Values In Terms of U.S. Dollars
		Grams of fine gold per currency unit	U. S. cents per currency unit
Mexico	Peso	0.071 093 7	8 000 00
Netherlands	Guilder	0.245 489	27 624 3
Norway	Krone	0.124 414	14.000 0
Pakistan	Rupce	0.186 621	21.000 0
Panama	Balboa	0.888 671	100 000
Paraguay	Guaraní		
Peru	Sol		
Philippines	Peso	0.444 335	50 000 0
Saudi Arabia	Riyal	0.197 482	22.222 2
South Africa	Rand	1.244 14	140 000
Spain	Peseta	0.014 811 2	1.666 67
Sweden	Krona	0.171 783	19.330 4
Turkey	Lira	0.098 741 2	11.111 1
United Kingdom	Pound Sterling	2 488 28	280 000
United States	Dollar	0.888 671	100.000
Uruguay	Peso	0.120 091	13.513 5
Venezuela	Bolívar	0.265 275	29 850 7
Yugoslavia	Dinar	0.002 962 24	0.333 333

Source: *Annual Report of the International Monetary Fund*, 1961, pp. 184-186.

became then a "gray market." In some countries the gray markets acquired legal status, and there were then two rates of exchange, the official and the gray (or free) market rates.

*Computation of official fixed pars of exchange.* Official, fixed pars of exchange are usually established to meet certain criteria. A government might desire an equilibrium rate, a rate which will increase its holdings of foreign exchange or one which is designed to meet other national objectives. An equilibrium rate is designed to maintain a nation's international reserves at a given level. If its present reserves are adequate and the rate of growth of imports is not large, such a rate might prove satisfactory. If a nation expects some expansion in imports, a rate might be established which will allow for this growth. A country maintaining reserves amounting to 30 per cent of its imports which are growing by \$100 million annually will require a rate of exchange that will augment its foreign exchange earnings by \$30 million each year. National objectives may include the use of overvalued and undervalued rates to promote either imports or exports. Where a nation depends upon a few crops for its

earnings of foreign exchange and the terms of trade turn against it, it might establish a rate which overvalues its currency to counteract the unfavorable terms of trade.

The actual computation of the rate may be made by one of two methods. A purchasing power parity rate, computed as outlined in a previous section of this chapter, will generally give reasonably satisfactory results. The purchasing power parity rate can, if so desired, be adjusted to bring it to reflect national objectives by either over- or undervaluing it.

If a nation desires to establish an *absolute*, rather than a *relative* rate, it must calculate it by the use of domestic and foreign data. It must know or be able to estimate the elasticities of the demand for its exports and imports as well as the character of their supply curves. Supply curves are of the constant cost type, where all quantities can be obtained at approximately the same per unit cost, the increasing cost type, where additional amounts can only be obtained at higher per unit costs and the decreasing cost type where a larger volume can be obtained at lower per unit costs.<sup>13</sup> Using data such as these, demand and supply schedules are computed for a country's currency as well as those of the currencies of its trading partners and rates are estimated from their equilibrium points. Because of the lack of data and the many estimates involved, absolute rates are only computed for nations with a limited number of exports and imports. In the case of nations with a wide variety of internationally traded products, the difficulties in the use of this method are virtually insurmountable.

In the practical matter of calculating official, fixed pars of exchange certain rules are often observed. The economic reasoning underlying these rules is based upon the fact that an overvalued rate renders imports cheaper and exports more expensive by raising the prices of the former and lowering those of the latter while an undervalued rate has the opposite effects.

1. Where the demand for a nation's exports is inelastic, an overvalued rate of exchange will generally yield larger foreign exchange earnings. Where demand for its exports is elastic, an undervalued rate will bring larger earnings.

2. Where the supply of exports is produced under increasing costs, an undervalued rate generally earns more foreign exchange; where it is produced under decreasing costs, an overvalued rate will yield more foreign exchange, and where the supply is one of constant costs, the actual rate is likely to make but small difference in these earnings.

3. Where a nation's demand for imports is inelastic, an undervalued rate will usually involve a smaller drain on its international reserves.

<sup>13</sup> These different types of supply curves are described in greater detail in Chapter 21.

Where its demand is elastic, an overvalued rate tends to conserve reserves.

4. Where the supply of imports is produced under conditions of increasing costs, overvalued rates mean lower drains on its foreign exchange; where it is produced under decreasing costs, an undervalued rate protects its reserves and where the supply is one of constant costs, the actual rate is not a matter of great importance.

### Inconvertible Paper Money—Multiple Exchange Rates

Until the end of World War II most nations established a single par of exchange applicable equally to all types of international transactions. Under the old gold coin standard there was but one par of exchange, and under most of the older paper money standards a single par was deemed sufficient.

After World War II some countries established several pars of exchange, each applicable to a given type of transaction or merchandise. The simplest form of the multiple exchange rate system is probably that employed at one time by the U.S.S.R. In that country between the end of the war and 1960, the official par was four rubles to the dollar, a rate which exaggerated the value of the ruble. Another rate, the tourist rate, was ten rubles to the dollar and was available to American tourists in Russia. Under the official par of four rubles to the dollar the Russian authorities felt that travel to their country would be discouraged by the high prices prevailing when dollars were exchanged into rubles at that rate. At ten rubles to the dollar travel was far less expensive and more attractive to Americans and such travel in the U.S.S.R. was an important Russian export of services.

*Objectives of multiple rates.* This practice of the U.S.S.R. illustrates one of the functions of multiple exchange rates. These rates serve to encourage the export of certain categories of goods and types of transactions and to discourage that of others, to encourage the imports of some goods and transactions and discourage others. No single rate is well adapted to all industries and all products, some are benefited, others are not. A system of multiple exchange rates designed to please everyone, however, would mean foreign exchange chaos.

*Examples of multiple exchange rates.* At one time Spain had a number of different rates of exchange, each applicable to a different group of goods. The rates were low for goods which the government desired to export and high for those which it desired to retain at home. The rates were high for imports which had the government's approval and low for those which it did not seek to encourage.

In 1936 the Argentine authorities fixed or recognized four separate exchange rates, the official rate the railway remittance rate, the import

rate and the free rate. In 1948 the French government again devalued the franc and fixed an official rate of 214 francs to the dollar. But it also recognized the Paris free market where the franc was quoted at a lower than official rate in dollars, Portuguese escudos and Swiss francs. At that time the government of France held that "non-essential" imports from the United States, Portugal and Switzerland had to be paid for in currencies purchased on the free market, but it permitted exporters to these countries to sell half of their foreign exchange earnings on the free market and the other half officially. In October 1948 the Paris free market was trading in dollars at the rate of 313 francs to the dollar. Consequently a French exporter to the United States could sell half of his dollars at 313 and the other half at 214 for an average rate of 263½ francs to the dollar.<sup>14</sup>

Although condemned by the Fund and frowned upon by the United States and some other countries, the system of multiple exchange rates is not without its partisans. The problem of multiple versus single rates involves some concepts which are beyond the scope of this book. Suffice it to say that a single rate of exchange has the weight of long tradition behind it and is far less subject to abuse than a multiple rate system.

The foreign exchange rates of some of the major trading powers assume a larger role in the mechanism of international payments because their currencies are used by other countries to finance international transactions. These currency arrangements, known as monetary areas or zones, are described in the following chapter.

## QUESTIONS AND PROBLEMS

1. Before the outbreak of World War I in July 1914, the par of exchange for the French franc was \$1.00 equalled 5 1625 francs. Following the severe inflation in France during and after this war French wholesale prices had risen by December 1926 to 718 and those in the United States to 156 (both price series on the base, July 1914 equal 100). Compute the purchasing power parity rate of the franc-dollar exchange as it stood in December 1926.
2. During the Great Depression of the 1930's many nations, including the United States, undervalued their currencies. During World War II some of the belligerents maintained overvalued rates of exchange. Explain this shift in exchange rate policy.
3. Should the United States have a multiple exchange rate system? Why or why not?
4. A Communist country has a state monopoly over foreign trade. Assume that rice is its most important import and that it is produced under conditions of increasing costs. This country desires to minimize the costs of this import. What should its purchase and exchange rate policies be?

<sup>14</sup> See, Crump, Norman, *The A B C of the Foreign Exchanges* London: Macmillan and Co., Ltd., 1958, pp. 231, 237.

5. Automobiles and trucks, produced under conditions of decreasing costs, are the most important export of a given country. The demand for these items is assumed to be elastic. What foreign exchange rates would the automobile industry be likely to advocate in this country?
6. Since World War II a nation has had a consistent deficit in its balance of payments with payments exceeding receipts in every year. Could this situation be corrected by an adjustment in its rates of exchange?
7. Would devaluation of the dollar remedy continuing deficits on the United States balances of payments? Why or why not?
8. What are likely to be the effects of each of the following upon a nation's rate of exchange assuming that it had no import or exchange controls and freely floating rates: a) An increase in merchandise exports; b) An increase in transportation imports, c) An increase in travel abroad of its citizens; d) A decrease in direct investments abroad, e) An increase in receipts from immigrant remittances from abroad?
9. Under the gold coin standard, economists assumed that there was a tendency toward an international level of prices. Does such a tendency prevail under today's paper money standards?
10. If exchange arbitrage were abolished by all nations, what might the effects be upon rates of exchange?

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## Regional Monetary Systems: Blocs, Areas and Zones

David Kinley, one of the early American contributors to the development of the science of money, stated in 1904:

"The adoption of a common monetary system by the great nations of the earth has been prevented partly by national prejudice, and partly by the inconvenience involved in making the change. Each nation is unwilling to give up its own system, and is ready to consent to the adoption of a common coinage only if its monetary unit is made the common one.

"Moreover, each country is anxious to get whatever advantage in trade is brought by the use of its coins in other countries. There is a feeling that German or English trade, for example, will be promoted in the Orient by the use of the German or the English coins. While there is some force in these contentions, the benefits that would accrue from a unification of the world's monetary system would far outweigh any detriment that might come to particular countries."<sup>1</sup>

In addition to Kinley's observations, one might add that a world monetary system would require a universal monetary authority, a single monetary unit and uniform rules applying to all nations using it. Few nations, in the present state of international integration and cooperation, would be willing to give up that important perquisite of national sovereignty, control over its monetary system, which such an arrangement would entail. The nearest approach to a world monetary system that exists today is the currency bloc, area or zone.

A monetary bloc, area or zone consists of a central or metropolitan monetary authority (metropolis) and other countries which use the money and exchange facilities of the central authority in their foreign transactions and hold their banking and international reserves in its finan-

<sup>1</sup> Kinley, David *Money A Study of the Theory of the Medium of Exchange* New York The Macmillan Co., 1904 Pp. 8-9

cial institutions. The value of the monetary units of the member countries is expressed in terms of that of the metropolitan country and is maintained at a par with it. The monetary laws and regulations of the metropolis, including exchange controls, are the model for those used by the member countries.

*Development of monetary zones.* The more important monetary areas are the *Sterling Area*, the *Franc Zone*, and the *Escudo Area*.<sup>2</sup> They find their antecedents in the Mercantilist period of economic development. When the European nations started to trade with newly discovered lands, they found either no money in use in the modern sense of the term or money which was adapted only to domestic transactions. They therefore carried on trade with them by using their own currencies. One of the many objections directed against the early British East India Company was that it exported British coins and specie to India to use in its transactions with that country.<sup>3</sup>

When these overseas lands became colonies and sufficient trade with them developed, the metropolitan countries sometimes devised currency systems for them. The gold exchange standard, created to meet their needs, had the advantage of preserving a colony's own currency for its domestic use while placing it on a virtual gold standard as far as international transactions were concerned. The gold exchange standard may be regarded as the predecessor of some currency areas which now use foreign exchange instead of gold as their international reserves.

### The Sterling Area

As British colonial trade developed, various members of the Empire tied their currencies to the pound, used the facilities of the London money market and kept their monetary and international reserves in London. The pound was then one of the world's most stable currencies, the facilities of the London money market were the world's best and cheapest, London was a leading capital center and the economic and political ties which bound members of the Empire to the mother country were strong.

*The Sterling Bloc* Shortly after the outbreak of World War I, the

United Kingdom abandoned the gold standard and went on a paper money basis. After peace had been established, considerable pressure developed again to place the pound on the gold standard, and in 1925 the gold bullion standard was adopted at the old par of exchange of 4.8665 dollars to the pound. At this rate the pound was overvalued, and Great Britain experienced difficulty in exporting. Industrial production declined, unemployment rose, and with the advent of the Great Depression, Great Britain abandoned gold in 1931 and has been on a paper standard ever since.

Nineteen-thirty-one was a year of decision for the members of the Empire and for those independent countries which had tied their currencies to sterling, for they had to decide whether or not to continue to maintain their currency links with the pound. The British colonies and dependencies, India, Ceylon and Burma apparently had no alternative but to continue to use the pound. Australia, New Zealand, Egypt and Iraq decided to remain in the system and were joined later by South Africa, the Baltic countries, Norway, Sweden, Denmark, Iran, Japan, Argentina, Uruguay, Yugoslavia and Greece. The decision was rendered more difficult for these countries because France and the Franc Zone, as well as some other nations, were on the gold standard and were known as the gold bloc countries.

The Sterling Bloc which emerged in 1931 from this monetary grouping was a loose association of members. There were few written rules; members freely entered and withdrew. They could appreciate or devalue their currencies, gold could still be obtained in exchange for sterling at its current market price on the world's gold markets. As a matter of practice, the member countries endeavored to maintain fixed pars with sterling, although the values of their currencies sometimes fluctuated. In 1938 the London sterling balances of members of the Sterling Bloc amounted to £760 million or about \$3.1 billion at the then current rate of exchange.<sup>4</sup>

*Transformation of the Sterling Bloc into the Sterling Area.* The pre-World War II Sterling Bloc was frequently termed a club because of its loose organization and the large amount of freedom enjoyed by its members. With the outbreak of the second World War in 1939, the Bloc changed its character, it was no longer a loose association of free members but a tightly knit, well-organized institution and henceforth was called the Sterling Area.<sup>5</sup> Great Britain instituted a rigorous system

<sup>4</sup> Cf. Bell, Philip W. *The Sterling Area in the Postwar World*. Oxford: The Clarendon Press, 1936, p. 22.

<sup>5</sup> When the Sterling Bloc became the Sterling Area, its membership shrank considerably. The countries which elected to remain, in addition to the United Kingdom, included, with the exception of Canada, the members of the British Commonwealth, Eire, Iceland, Iraq, Egypt and the Sudan.

of export, import and exchange controls which applied to all transactions between members of the Commonwealth (with the exception of Canada, Newfoundland and Hong Kong) and the rest of the world. All members of the Sterling Area were required to adopt regulations patterned on those used by the United Kingdom. The Sterling Area controls were administered by the member countries under the general supervision of the Bank of England and the Board of Trade and formed an integral part of the United Kingdom's program of economic warfare. All Sterling Area imports on the current account required a license before foreign exchange was issued to pay for them, and only essential transactions were permitted. Licenses for the export of capital were required and were difficult to obtain. The trading areas within and outside of the Area were divided into a number of accounts and transactions were controlled by a complicated system of regulations. These regulations served to pool the foreign exchange earnings of all of the members of the Area, to minimize the drain on these reserves and to place them at the disposition of the United Kingdom to be used in the prosecution of the war.<sup>6</sup>

At the outbreak of World War II the United Kingdom, given the cash and carry provisions of the United States Neutrality Act, sold publicly and privately held foreign securities to insure sufficient foreign exchange to prosecute the war. The advent of Lend-Lease early in 1941 served to ease the United Kingdom's foreign exchange stringency; a total of about \$44 billion was supplied in the form of Lend-Lease by the United States to its Allies including the U S S R. It is important to note, however, that the United Kingdom, in addition to utilizing United States Lend-Lease, spent much of the foreign exchange earnings of the Sterling Area members which were deposited in the London pool. Had it not been for the Sterling Area and the heavy contributions of foreign exchange of the member countries, the United States would doubtless have found it necessary to supply even more Lend-Lease to this leading Ally. The Sterling Area, therefore, in addition to serving the wartime goals of the United Kingdom, helped to economize United States Lend-Lease outlays.

*London pool foreign exchange accumulations.* The exchange and import controls of the members of the Sterling Area, the stringent supplies of goods available for import and the large purchases by the United Kingdom from the several members of the Area on credit, resulted in the accumulation by the members of large balances in the London pool which

they were not able to use during the war. These constituted, in effect, short-term credits granted by members of the Area to the United Kingdom. These balances were in sterling, because when a member earned foreign exchange through exports outside of the Area it was given credit in sterling in the pool at the official rate of exchange. Conversely, when a member required foreign exchange for approved imports from countries outside of the Area, London supplied the exchange at the official rate and charged the member's account in sterling. Transactions with members of the Area itself took place in sterling and involved no other foreign exchange.

The sterling balances of members stood at £760 million or \$3.1 billion in 1938 and at £3 863 million or \$14.8 billion in 1945 at the prevailing rates of exchange. This represented an increase of approximately 475 per cent in these balances during World War II. At the close of the war they presented a serious financial problem for the United Kingdom. They meant, in law at least if not always in practice, that the Area could import goods or receive investments from the United Kingdom up to the amount of its holdings without exporting or investing in this country in return. In addition, a member could use its balances to import or receive investments, up to the amount of its holdings, from any other member of the Sterling Area without giving anything in return. The exports made by drawing down these balances were termed "unrequited exports."

Given the large size of these balances, the United Kingdom could not allow a member nation to use all of its balances at once, and some way out of the impasse had to be found. Two solutions to the problem were elaborated: payments agreements were made with the Sterling Area members, and credits from the United States and Canada were sought to tide the United Kingdom over its difficulties.

Agreements were made with several members of the Area to limit the amount of the sterling balances which could be withdrawn in a stated period and to make provision for the utilization of future exchange earnings. No balances were scaled down as a result of these negotiations and the drawing provisions were quite liberal, so much so that they placed a strain on the British economy.

*The Anglo-American loan* Although these special payments agreements did much to alleviate Britain's post-war balance of payments problems, they did not solve them entirely. United States and Canadian dollars were needed.

In 1945, representatives of the United Kingdom came to the United States to seek help. The agreement which they negotiated provided for a loan of \$3.75 billion for balances of payments purposes plus about \$650 million to aid the United Kingdom to pay for the Lend-Lease goods in

the pipeline and on order when Lend-Lease grants were terminated. Early in 1946 Canada followed the lead of the United States by making the United Kingdom a loan of \$1.25 billion under quite similar terms.

*Contributions of Sterling Area members to the system's reserves.* With the shift to a peacetime economy at the end of World War II and with the tasks of reconstruction, new regulations for the Area were needed.<sup>7</sup> These were provided by the British Exchange Control Act of October 1947. This Act was modified from time to time as the foreign exchange position of the Area changed, and they are now primarily of historical interest because sterling is now largely a convertible currency.

Table 10.1 shows the overseas holdings of sterling during selected post-war years. It should be remembered in interpreting this table that the United Kingdom devalued the pound in September 1949 from \$4.04 to \$2.80. In June 30, 1960 at the present official par of exchange, total outstanding holdings of sterling amounted to \$12 billion. Those of the members of the Sterling Area increased somewhat during the period and amounted to almost \$7.5 billion in June 1960.

The transactions of the Sterling Area, arranged to show the deficits and surpluses of the United Kingdom and the rest of the Area, are presented on Table 10.2. The United Kingdom, between 1946 and 1959, had a deficit on its balance of payments with the non-Sterling Area, except in 1950 and 1958, but a surplus with the members, in each year except 1953. The other members showed a surplus in their trade with the countries of the non-Sterling Area in every year except 1947 and 1957. Since the end of World War II the other members of the Sterling Area have generally been net earners of foreign exchange and the United Kingdom has been able to use some of these accumulations to finance a part of its deficit with the rest of the world. Without the Area, the United Kingdom would have had to restrict its purchases from other countries and re-orient its foreign economic relationships.

*The future of the Sterling Area.* With the increasing convertibility of the pound, the Sterling Area has become less a system of cooperative exchange controls and more a system of multilateral payments. In certain respects, the Area has reverted to the role which it played between 1931 and World War II when it was known as the Sterling Bloc.

Since World War II, Britain has shifted from a creditor to a debtor nation and now relies to a certain extent upon the earnings of the rest of the Sterling Area for a part of the foreign exchange required for its imports and investments. In exchange for this advantage, the United King-

TABLE 10 1  
OVERSEAS STERLING HOLDINGS, BY AREA  
(In millions of pounds sterling)

	1946	1950	1955	1959	1960 <sup>1</sup>
Sterling Area countries	2428	2549	2764	2704	2674
Non-Sterling Area countries	1301	934	612	803	940
Non-Territorial international organizations	26	577	469	705	661
Total outstanding	3755	4060	4045	4212	4275

<sup>1</sup> As of June 30, 1960.

Source *Balance of Payments Yearbooks*, International Monetary Fund

TABLE 10 2  
STERLING AREA TRANSACTIONS THROUGH THE UNITED KINGDOM  
(In millions of pounds sterling)

Year	Transactions of the U K		Transactions of the Rest of Sterling Area with non-Sterling Area
	Balance with non-Sterling Area	Balance with Rest of Sterling Area	
1946	-119		1
1947	-640		-281
1948	-160	-	62
1949	-241		18
1950	107	108	487
1951	-674	154	230
1952	-257	273	168
1953	-120	-54	295
1954	-98	77	175
1955	-284	188	143
1956	-295	251	217
1957	-34	79	-43
1958	80	133	44
1959	-204	116	301

Source *Balance of Payments Yearbooks*, International Monetary Fund.

dom offers the members of the Area the unparalleled facilities of the British money market with its many agencies for financing foreign trade, with its stable and widely-accepted currency and with ready access to capital.

The United Kingdom needs the exchange earnings of the other members of the Area, the Overseas Members need the facilities of the United Kingdom and the future of the Area is doubtless to be found in these mutual interests. If the Area were to be abolished, many of the members, with the exception of the United Kingdom, would find it necessary to join some other currency area because their currencies are not international and they do not possess the requisite financial institu-

tions to handle their foreign transactions. Few other currencies, even the dollar, offer the advantages of the pound to trading nations. The dollar is primarily a reserve currency and the pound a trading currency.

If the Sterling Area were to disappear, Britain might find it necessary to reimburse the other members for their sterling holdings which amounted to almost \$7.5 billion in June 1960. A withdrawal of this magnitude would seriously deplete British holdings of foreign exchange. If these holdings were used to buy British goods and services, the United Kingdom would doubtless need to pass through another period of austerity as it did in the years immediately following World War II. Without the contributions of the other members to currency reserves, Britain's status and standard of living are likely to fall unless other means of earning foreign exchange could be found.<sup>8</sup>

### The Franc Zone

Although the Franc Zone, like the Sterling Area, is a regional monetary organization, it presents a sharp contrast in two important particulars to the latter organization. Whereas the Sterling Area is now a loosely organized group with relatively few written rules, the Franc Zone is tightly organized, highly centralized and formal. Secondly, the members of the Sterling Area have been net contributors to the foreign currency reserves of the Metropolis while the Territorial Members of the Franc Zone have been net drawers on the foreign exchange of the system which generally has been accumulated by France itself.<sup>9</sup>

The Franc Zone has its roots in the French Empire and, during its history, has changed as the French *Régime Colonial* itself has. Each member nation or territory has its own monetary system; some have private and some government-owned banks of issue, all of which are

<sup>8</sup> In 1961 the Sterling Area comprised the United Kingdom, Australia, Burma, Ceylon, Cyprus, Ghana, Iceland, India, the Irish Republic, the Hashemite Kingdom of Jordan, Libya, the Federation of Malaya, New Zealand, Nigeria, Pakistan, the Federation of Rhodesia and Nyasaland, the State of Singapore, the Union of South Africa together with all British Colonies, Protectorates, Protected States and Trust Territories.

<sup>9</sup> The Franc Zone, in 1961, included the territory of the French Republic (continental France, Corsica, the Department of Algeria, Oasis and Sahara), the Overseas Departments (Guadeloupe, Martinique, Guiana and Réunion), the overseas territories except French Somaliland (Comoro Islands, St Pierre and Miquelon, New Caledonia, Wallis and Futuna Islands and French Polynesia), the Condominium of the New Hebrides, the Republic of Cameroon, the Central African Republic, the Republic of Chad, the Republic of the Congo (Brazzaville), the Republic of Dahomey, the Gabon Republic, the Republic of Guinea, the Republic of the Ivory Coast, the Malagasy Republic, the Republic of the Mali, the Islamic Republic of Mauritania, Monaco, Morocco, the Republic of the Niger, the Republic of Senegal, the Republic of Togo, Tunisia and the Republic of the Upper Volta.

under the general supervision of the Bank of France.<sup>10</sup> The budgetary relationship between France and the other members shows considerable variation; some have considerable autonomy in fiscal policy while others are supervised by the Metropohs.

In treasury administrative matters the Franc Zone is highly centralized and the principle of unity, or single treasury, is the rule. A single accounting system and reserve fund are maintained for the members of the Zone. The Algerian and Tunisian treasuries exercise some autonomy, but certain overseas territories are treated as though they were departments of France itself. In the early days of the French colonies the sole bank in many of them was the official bank of issue. With colonial development, private banks established branches in these areas and considerable competition in the banking field resulted.

*Exchange controls* The Franc Zone moneys are maintained at a fixed par with the French franc and (like those of the Sterling Area) are freely convertible among the members of the Zone, but exchange controls are applied to monetary transfers with countries lying outside of it. The more important of these controls were instituted at the start of World War II by the law of September 9, 1939 and were amended by the post-war order (*arrêté*) of July 15, 1947. With the emergence of the franc as a stronger currency in the fifties, strict exchange controls were no longer needed and they have been gradually relaxed.

Each territory in the Zone has its own exchange control organization operating under the general regulations and supervision of the Bank of France, the Ministry of Finance and Economic Affairs and the Central Fund of Overseas France (*Caisse Centrale de la France d'Outre-Mer*) in Paris. Generally speaking, and again like the Sterling Area, residents of the Zone can engage in current account transactions with each other with considerable freedom, the controls are applied principally to dealings between residents and non-residents and to capital movements. Residents of the Zone are required to turn over certain earnings of foreign exchange, through authorized agencies, to the Exchange Office and those who require it for specified imports or overseas investments must obtain it through these agencies.<sup>11</sup>

*Foreign exchange reserves.* On October 1, 1936, France created an Exchange Stabilization Fund (*Fonds de Stabilisation des Changes*) which was importantly modified at the outbreak of World War II, on September 9, 1939. This Fund is generally charged with the task of stabilizing the exchange rates of the franc and the colonial currencies. Although the banks of issue of the Franc Zone are separate institutions, there are close financial relations between them, the Stabilization Fund and the Treasury. The volume of money and credit in circulation in some of the countries of the Zone tends to fluctuate with their balances of payments, increasing with surpluses and declining with deficits.

Frequent periods of monetary inflation in France and in the other Zone member-countries combined with fixed rates of exchange, which then became overvalued, have impeded the Zone's ability to export and increased its imports, thus working toward balance of payments deficits. The franc was overvalued during the war years as well as in some of those immediately following. After the war, the franc was devalued from time to time to bring its fixed rate into line with its market value. The rates of exchange of some of the overseas territories, notably the francs of the French African Colonies and the French Pacific Colonies, were devalued on several occasions as well but not always in proportion to the change in value of the metropolitan franc.

*Contributions of France to the Zone members.* Table 103 presents the balance of payments surpluses and deficits of the Franc Zone with the rest of the world for the period 1945-1959, divided between those of metropolitan France and the Overseas Members. In only three years, 1954, 1955 and 1959, did the Zone as a whole have a surplus, in all of the others it had a deficit. Except in 1959, the Overseas Members of the Zone had a deficit on their balances of payments. Metropolitan France showed a surplus in only 1954, 1955, and 1959.

The deficits on the balances of payments of the Franc Zone, which have been substantial and appear to be unsustainable, were met by American aid of various types (which was especially large between 1948 and 1955), receipts under compensation agreements, drawings on the European Payments Union and a reduction in gold and foreign exchange reserves. In a certain measure the declines in the par values of the franc which characterized this period may be attributable to these deficits.

The Overseas Members of the Franc Zone were a burden on the balances of payments of metropolitan France and, unlike those of the Sterling Area, only contributed foreign exchange earnings to the Zone as a whole in 1959. These members have relied heavily upon the gold and foreign exchange accumulations of France, without them, their standards of living would have to be substantially reduced.

TABLE 103

## FRANC ZONE

## BALANCE OF PAYMENTS SURPLUSES AND DEFICITS WITH THE REST OF THE WORLD

(In millions of current dollars)

	Overseas Members	Metropolitan France	Total
1945	-374.6	-278.9	-653.5
1946	-296.7	-712.9	-1099.6
1947	-162.6	-204.6	-367.2
1948	-207.5	-939.0	-1146.5
1949	-167.3	-616.2	-783.5
1950	-123.1	-92.3	-215.4
1951	-88.0	-930.0	-1018.0
1952	-26.1	-488.8	-514.9
1953	-60.4	-126.0	-186.4
1954	-10.7	+39.3	+28.6
1955	-148.8	+423.0	+274.2
1956	-107.5	-783.4	-890.9
1957	-159.7	-889.0	-1048.7
1958	-112.0	-163.6	-275.6
1959	+47.0	+699.0	+746.0

Note For the period 1945-1951, the surpluses and deficits of the Overseas Members are those for the current account and unilateral transfers, for the period 1952-1959, the surpluses and deficits include those on the current account, unilateral transfers and capital movements

Source Computed from data in *La Balance des Paiements Etude Methodologique*, prepared by the Institut National de la Statistique et des Etudes Economiques, Bureau d'Information du Public, Paris, 1957 and *Annuaire Statistique de la France*, Paris, 1961

*Other aspects of the Franc Zone.* The moneys of the Franc Zone, for which the metropolitan franc serves as a standard, are convertible among themselves without restriction. Since 1951, a Monetary Committee of the Franc Zone (*Comité Monétaire de la Zone Franc*) has been charged with the coordination of the Zone policies, but in practice it has limited its functions to those of control rather than those of planning and coordination and the Bank of France has been largely responsible for Zone monetary policy. Like the Sterling Area, the Franc Zone provides a system of multilateral trade for its members. The Overseas Members are doing an increasing amount of trade with the Metropolis; they account for about one-fourth of its imports and almost one-third of its exports. The trade of metropolitan France with the other members has often taken place at non-competitive prices which have averaged about 20 per cent higher than some other international prices.

More than any other monetary area, the Franc Zone is a convenient arrangement for the distribution of economic aid to the Overseas Mem-

bers. Private investment, either of French or other origin, in the Zone territories is relatively unimportant while the investment of French public funds is large. Much French government investment has been made at a rate of interest of about 3 per cent. Some of these loans form the counterpart of the drawings by the members on the reserves of gold and foreign exchange held by the central fund in Paris, while others have been made for developmental purposes. On the other hand, private residents of the Overseas Members of the Franc Zone, principally French colonists, have been heavy investors in France. The expenditures of France for civilian and military purposes in the countries of the Zone have proved of considerable assistance to these territories. Next to the United States, France has contributed more foreign aid to other countries than any other nation. Unlike American aid, most of it has been directed to its colonies, territories and dependencies.

*Advantages and Disadvantages of the Franc Zone.* In addition to the advantages and disadvantages of the Franc Zone which resemble those of other monetary areas, there are a number of others which are peculiar to it. It is a great advantage to the members of the Zone to be able to draw on the central exchange holdings in Paris for their payment requirements even though they must seek credits for this purpose. If properly utilized, these drawing privileges can contribute to economic development by providing the exchange needed for the acquisition of capital and supplies.

The fact that France must sustain the members exchange-wise constitutes a drain on the French reserve position and has constricted somewhat that nation's freedom of action in international economic affairs. The British tend to be debtors on the short- and creditors on the long-term capital account, while France is a creditor on both the short- and long-term.

The Franc Zone is more highly centralized and exhibits less flexibility than the Sterling Area and, in addition, tends to tie the trade and investment of the members more closely to France than the Sterling Area does to the United Kingdom. There is also a tendency for Paris to dictate the terms and conditions of Zone affairs, and members do not have a very large voice in these matters. Perhaps if the membership of the Monetary Committee of the Franc Zone included more representatives of the overseas territories and if it were given a larger voice in the determination of the Zone policies, a greater degree of monetary democracy would prevail.

It is doubtful that many members of the Franc Zone would find it to their advantage to leave it. Although French tutelage may appear excessive to members, if they were to leave the Zone they must be pre-

pared to go it alone and forsake the advantages in the form of advances of short-term credit, long-term loans and economic aid which the Metropolis has given them. The franc and the Parisian money market are far superior to the moneys and exchange markets of the overseas territories. It would be easier for a member of the Sterling Area to leave that organization than for a member of the Franc Zone to withdraw.

As far as France is concerned, the reasons for the continuance of this institution may be outside of the monetary aspects of the Zone, for it has proved a costly institution to the Metropolis. The Zone has been a part of the French colonial system and a part of France's relations with the outside world. French business has profited through trade with the Zone while its expenses have partly been met through the French fiscal system and taxation.

*Future of the Franc Zone.* The Franc Zone is, in the opinion of some French economists, at a turning point. Although most of the newly-independent lands have elected to remain in the Zone, some of them apparently yearn for monetary independence. The growing economies of the Overseas Members are likely to constitute an even greater drain on France's holdings of gold and foreign exchange as they import more equipment and supplies for development. The European Common Market with the monetary sections of its charter may also bring changes in the Zone, as might also the European Monetary Agreement. These contingencies point to the possibility that the Franc Zone may be altered substantially in the years ahead.

As the changes which the Sterling Area has undergone indicate, monetary areas are subject to alteration and the Franc Zone must doubtless adapt itself to shifting world circumstances. It is difficult to forecast what these changes will be, but indications point to the possibilities of greater flexibility in its organization, more democratic administration and policy determination together with greater monetary cooperation among metropolitan France, the Overseas Members and the rest of the world, especially Europe.<sup>12</sup>

The French franc has gone a long way on the road to convertibility, and the Zone is losing its importance as a multilateral system of exchange controls. There is a high degree of complementarity in the trading relations between metropolitan France and the Overseas Members with these members purchasing finished goods and equipment from, and exporting raw materials to, France which exports equipment and finished

<sup>12</sup> Cf. Leduc, Gaston, "L'Organisation de la Zone Franc: Evolution Récente et Vues d'Avenir," *Revue d'Economie Politique*, May-June 1959, pp. 335-350 and Moussa, Pierre, "Fonctionnement et Equilibre de la Zone Franc," *Revue d'Economie Politique*, May-June 1959, pp. 351-361.

goods to, and imports raw material from, them. In certain respects, the Franc Zone is a natural economic organization.

A number of French economists have pointed out that some of the Overseas Members would have difficulty in quitting the Zone. They rely upon metropolitan France for substantial fractions of their foreign exchange requirements, and were they to leave the Zone they would have to find other means of obtaining exchange or reduce their standards of living and rates of economic growth. There is reason to believe that some of the members might be able to obtain their finished goods and equipment at lower prices on other world markets and sell their raw produce to better advantage elsewhere. The net advantage, then, of Zone membership to the Overseas Members apparently lies in equating the benefits of membership against these disadvantages.

For France, the Zone has proved a relatively easy, protected market for its manufactures and a stable and inexpensive source of supply for some of its raw materials. French industry has been able to trade with the members under favorable conditions which shielded it from some foreign competition. If the Zone were to be abolished or altered, France would need to weigh the reduced drains on its holdings of gold and foreign exchange against the loss of the competitive advantages which it holds for certain segments of French industry.

### The Escudo Area

Like other areas and zones, the Escudo Area developed with the growth of the Portuguese Empire, and it has participated in the checkered financial history of the nation itself. During the nineteenth century, and prior to the reforms of Salazar in 1928, Portugal passed through several monetary and fiscal crises. The monetary reform of June 9, 1931 established the escudo on a form of the gold exchange standard and the paper money in circulation was supported by a reserve of gold and foreign exchange. This standard was short-lived. When the United Kingdom abandoned the gold standard in September 1931, Portugal gave up the gold exchange standard and tied its currency to the pound (although it did not join the Sterling Area when that organization was formed in 1939).

*Characteristics of the Escudo Area* Several different currencies, all with fixed pars in terms of the escudo, are used in the Area.<sup>13</sup> Portugal, the adjacent islands, the provinces of Cape Verde, Guinea, São Tomé, Príncipe and Mozambique use the Portuguese escudo, Angola employs

<sup>13</sup> The Escudo Area in 1961, consisted of Metropolitan Portugal, the Azores, Madeira, the Cape Verde Islands, Portuguese Guinea, São João, Baptista de Ajudá, the Islands of São Tomé and Príncipe, Angola, Mozambique, the Portuguese Indies (Goa, Damao and Diu), Macao and Portuguese Timor.

the angular, Goa the rupee, Timor and Macao, the pataca. The Banco do Portugal issues escudos, the Banco do Angola, angolars; and the Banco Ultramarino in Portugal the rupees and patacas. These banks are privately owned, and the amount of money which each may issue is controlled by the government of Portugal.

Under the control of the central government, each colony has had a certain degree of autonomy since 1933 in its financial affairs. In 1951 the colonies were termed overseas provinces, and their autonomy was increased. Monetary transfers between members of the Area are free, but exchange controls between the Area and other countries are administered by the Metropolis. Import and exchange licensing, according to the Portuguese standards, apply to transactions with outside countries. Residents of the Area are obliged to turn their earnings of foreign exchange, either directly or indirectly, over to the Bank of Portugal and those who require it for foreign transactions must obtain it from the same source. Transactions between the Area and other countries take place in escudos.

Prior to 1946 Portuguese exchange controls were not very strict. During World War II the Escudo Area accumulated large holdings of foreign exchange for many of the members were neutral and sold large amounts of raw materials to the Allies. After 1946 these reserves were drawn down due to the heavy imports of the Area and the fact that one of the principal customers, the United Kingdom, was going through a period of austerity with tightly controlled and reduced imports.

The rather close relation between the Sterling and Escudo Areas has loosened somewhat during recent years. Portugal joined the European Payments Union in 1951, and its currency was one of the stronger ones in that Union. Since Portugal is on a foreign exchange standard its earnings of exchange are one of the determinants of the total volume of money and credit in circulation. This volume may follow balance of payments surpluses and deficits, rising as the holdings of foreign exchange increase and declining as they fall.

In recent years the government of Portugal has taken steps to develop and to centralize its investments in its Provinces. A program of investment has been arranged, and a fund established for their development. A form of export tax has been levied upon the exports of specified raw materials and the receipts from the tax serve to build up this fund.

*Exchange earnings of the Area.* Table 10.4 shows the international transactions of the Escudo Area. During 1948-1959, metropolitan Portugal had a balance of payments deficit in every year, but the Overseas Territories and Area as a whole, except in 1948 and 1949, had a surplus. Since there has been a heavy inflow of both private and official capital as well

TABLE 104

## BALANCE OF PAYMENTS SURPLUSES AND DEFICITS OF THE ESCUDO AREA

(In millions of escudos)

Year	Balance of Metropolitan Area	Balance of Overseas Territories	Errors and Omissions	Net Balance Escudo Area
1948	-3149	45	138	-2966
1949	-2859	425	398	-2036
1950	-931	868	534	471
1951	-417	2331	265	2179
1952	-1670	1702	389	421
1953	-1223	2976	332	2085
1954	-955	2460	-117	1388
1955	-1050	1956	108	984
1956	-1430	2298	174	1042
1957	-2286	2242	219	175
1958	-1834	2962	52	1180
1959	-2694	2807	-15	98

Source: *Balance of Payments Yearbooks*, International Monetary Fund.

as unilateral transfers in the form of aid, during the period under consideration, Portugal's balance of payments deficit is found principally in the current account. The provincial or territorial members of the Area earned more than enough foreign exchange, except in 1948 and 1949, to counterbalance these deficits of the Metropolis. Exchange-wise, Portugal was heavily supported by the receipts of the overseas members of the Area and it is the only monetary area where such a situation prevails.

**Future of the Escudo Area.** The advantages of the Escudo Area to Portugal are obvious, but the advantages of the Area to the Overseas Territory members are not as clear. They enjoy the use of an internationally recognized currency, the resources of the Lisbon money market and the investments, official and private, of Portugal. Attached to another monetary area, or using another international currency, they would doubtless fare just as well, if not better. Several other currencies are superior to the escudo as international media of exchange, and other money markets are larger, more flexible and better organized than those of Lisbon. Since these territories are large net earners of foreign exchange, they would doubtless be welcome members of other currency areas or users of other metropolitan currencies for their foreign exchange transactions. Portugal and the overseas members of the Escudo Area are less complementary in foreign trade than the members of either the Sterling Area or the Franc Zone. The Escudo Area appears to be more politically- than economically-oriented.

The importance of the Overseas Territories of the Escudo Area to

the Metropolis doubtless explains, in part, the strong desire of Portugal to retain its colonial empire and the efforts of some of the territories to leave it. Of all the regional monetary arrangements, the Escudo Area has the most problematical future.

### Summary

Although the three regional monetary organizations, the Sterling Area, the Franc Zone and the Escudo Area, have much in common there are sharp differences among them. From the point of view of their foreign exchange position, the metropolitan countries vary from complete dependence upon the earnings of the members, as in the case of the Escudo Area, partial dependence as with the Sterling Area, to net contributions to the earnings of the members by the metropolis as in the case of the Franc Zone.

These areas and zones are often termed regional monetary organizations. The term regional is not here employed in a geographic sense, but to describe a situation which is more than national but not yet international. In addition, these institutions are also often called systems of multilateral trade and payments, but they are much more than that. They are devices for the pooling of foreign exchange and operate under the theory that a common pool of currencies is better for each member than a system of individual country reserves. In this respect, however, they are of greater advantage to some members of the pool than to others. Areas and zones tend to smooth out the peaks of high and low exchange earnings of all of the members, provide for exchange stability and afford a cushion which each member can use in time of stress.

The areas and zones introduce a strong measure of uniformity in the world's foreign exchange regulations and restrictions and make the life of the foreign trader somewhat easier since he has fewer systems and regulations to master. On the other hand, foreign exchange restrictions may be applied to areas which do not need and would not otherwise use them. These institutions also are devices employed to tie the trade of the members to the metropolis sometimes to the detriment of non-member countries. They serve to strengthen, or to replace, colonial systems by partially integrating the economic systems of the members with those of the mother country.

The next chapter examines the trade of nations in merchandise and services which is the largest earner and spender of foreign exchange and which renders these monetary unions an often useful adjunct of trading relationships.

## QUESTIONS AND PROBLEMS

- 1 Are regional monetary areas and zones a substitute for an international monetary system? Why or why not?
- 2 The statement has been made that monetary zones and areas had their beginnings in the days of Mercantilism. Explain what is meant by that statement.
- 3 Describe the changes which were made in the sterling monetary systems in 1931 and 1939 showing how these changes came about.
- 4 Describe the systems of exchange controls used by the monetary areas, explain why they were used and sketch some of their economic effects.
- 5 If the Sterling Area were to be dissolved what effects might this have on (a) the United Kingdom, (b) the member countries?
- 6 Should the Sterling Area be enlarged to include other nations? Explain.
- 7 Contrast the Sterling Area and the Franc Zone. In what ways are they similar and in what different?
- 8 Why does the French government continue the Franc Zone? Why do the other member states continue to adhere to it?
- 9 Should the Franc Zone be enlarged to include other states? Explain.
- 10 Sketch the principal features of the Escudo Area and contrast it with the Sterling Area and the Franc Zone.
- 11 Should Portugal attempt to enlarge the Escudo Area to include other countries? Explain.
- 12 Should the United States establish a Dollar Area similar to existing areas and zones? Why or why not?
- 13 Comment on the statement, "As long as the United Kingdom is the center of the Sterling Area, it no longer needs an empire."
- 14 If all currency areas were abolished would world trade be benefited or hindered?
- 15 Do monetary areas advance or retard the development of world trade?

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## The Current Account: The Export and Import of Merchandise and Services

"Nature seems to have intended that mutual dependence should unite all the inhabitants of the earth into one commercial family. For this purpose she has indefinitely diversified her own products in every climate and in almost every extensive district. For this purpose, also, she seems to have varied so extensively the wants and the productive powers of the different races of men. The superiority of modern over ancient wealth depends in a great measure on the greater use we make of these varieties."<sup>1</sup>

Nassau Senior's words provide a vivid expression of the nature of commercial relationships in the world economy. The international flow of goods and services is perhaps one of the strongest bonds among the peoples of many lands. Trade is an integrating factor because it creates interdependency or a mutual reliance on the output of other economies. A free movement of products not only helps satisfy the diverse wants of mankind, but it is also essential for a more effective use of scarce resources. In this chapter, the role of the United States in the flow of goods and services among nations is examined.

*Nature of the current account.* The transactions which reflect the export and import of merchandise and services comprise that part of the balance of payments known as the current account. In fact, however, there is nothing more "current" on this account than there is on the others. This is particularly true of short-term capital which frequently takes the current accounts counterbalancing entries. The reasons which underlie this grouping stem from the insistence of the Mercantilists upon the advantages of a favorable balance of trade on the merchandise and service accounts, and the usage which they originated prevails today.

<sup>1</sup> Senior, Nassau. *An Outline of the Science of Political Economy*. London: George Allen and Unwin Ltd. Published in The Library of Economics, 1938, p. 76. (First edition published in 1836.)

## The Balance of Trade of the United States

A country's balance of trade denotes the relationship between the value of merchandise exports and imports. As shown on Table 11.1, the U. S. has had a highly favorable balance on its merchandise trade since about 1940.<sup>2</sup> Merchandise exports have surpassed imports by an average of approximately \$5 billion each year since 1941. The favorable balance of trade is not a recent development. This country has maintained an export surplus in virtually every year since the late 1870's. Prior to that time the balance of trade was unfavorable for most years. A country's balance on merchandise accounts has a bearing on its international investment position. The United States was a net borrowing nation during its early history, a factor which permitted an import surplus at that time.

TABLE 11.1

EXCESS OF UNITED STATES MERCHANDISE EXPORTS OVER IMPORTS  
1921-1960

(in millions of dollars)

Yearly average	Value
1921-25	947
1926-30	744
1931-35	312
1936-40	737
1941-45	6,537
1946-50	5,170
1951-55	4,502
1956-60	5,544

Source: U.S. Department of Commerce, *Statistical Abstract of the United States 1961* (Washington 1961), p. 880.

The export balance on merchandise has been financed by the flow of United States private investment abroad, its foreign aid programs, the deficits on its service accounts during some periods and the occasional importation of gold.

## Importance of External Trade

The United States has an abundance of natural and capital resources; regions with wide variations in climate are included within its borders. It is highly dependent upon the rest of the world for a variety

<sup>2</sup> It should be noted that the data are here expressed in values. Because of price movements, however, a change in their value is not always exactly comparable to a change in the quantity of trade. Certain deficiencies exist in international trade statistics for international comparisons which stem from varying definitions and classifications, valuation and the rate of exchange employed.

of strategic materials despite its favorable environment for diversified production. This country is almost completely dependent upon foreign sources of antimony, beryllium, chrome, cobalt, industrial diamonds, manganese, natural rubber, nickel, platinum, tin and tungsten. Without these materials, many American industries would be forced to curtail or shift operations.

Additionally, the United States relies upon external areas for a variety of foodstuffs, especially tropical and semi-tropical commodities such as bananas, coffee, tea, cocoa and many types of spices which cannot be economically produced domestically because of climatic conditions. The economy could survive without these foodstuffs, but the selection available to consumers would be narrowed.

*Relative importance of trade* Despite the fact that the United States is dependent upon the rest of the world for certain materials, trade is not too important for this country in terms of total national income. As shown in Table 11.2 its exports in 1959 amounted to about 5 per cent, imports about 4 per cent, of national income. The low ratio of trade to income is primarily due to several factors: the national income of the United States is high, it is characterized by diversified production and is self-sufficient in many respects. It encompasses a large geographical area where production of a wide selection of commodities is possible. Much American domestic trade corresponds to the external trade within such continents as Europe and South America which are fragmented by national boundaries.

*Absolute importance of trade* The relative importance of external commerce can be quite deceptive. Its significance is frequently underestimated because it represents but a small percentage of national income. In absolute terms the combined value of merchandise exports and imports of the United States has surpassed that of any other nation since 1940. In a recent year its exports amounted to about \$17.5 billion and its imports, \$15.0 billion. The value of merchandise trade of the United Kingdom, the second largest in the world, was roughly only about one-half that of the United States. The Netherlands, with one of the highest ratios of international trade to national income, exported and imported from \$3.5 to \$4 billion worth of goods.

The importance of the international commerce of the United States is also suggested by the fact that its trade represents a large share of global commerce. According to the United Nations' *Yearbook of International Trade Statistics*, the total value of world trade increased from \$56.3 billion in 1950 to \$100.6 billion in 1960. The United States share of this trade ranged from about 17 to 21 per cent of the total.

*Employment related to international trade* The importance of ex-

TABLE 11 2

EXPORTS AND IMPORTS AS A PERCENTAGE OF NATIONAL INCOME  
FOR SELECTED COUNTRIES<sup>1</sup>

Country	Exports	Imports
Netherlands	43	47
Venezuela	42	25
Cuba	35	41
Denmark	31	36
Belgium-Luxembourg <sup>2</sup>	28	29
Finland	26	26
Switzerland	25	28
Union of South Africa <sup>3</sup>	24	28
Norway	24	39
Austria	23	28
Germany	22	19
Canada	20	23
Viet-Nam	20	60
Australia	18	17
United Kingdom	18	20
Argentina	17	17
France	14	13
Italy	13	15
Columbia	13	15
Japan	12	13
Israel	11	26
Philippines	11	10
Mexico	9	12
Brazil	7	11
United States	5	4

<sup>1</sup> For the year 1959

<sup>2</sup> Based on Gross National Product National Income not available for year reported

<sup>3</sup> Includes South West Africa

Source *International Financial Statistics* International Monetary Fund, Washington, D C, Vol XIV, No 2 Feb 1961, pp 17, 36-39, and 48-287.

ternal commerce is also reflected by the number of workers who gain their livelihood as a consequence of trade. It has been estimated that trade provided employment for about 7 per cent of the American labor force or about 4.5 million workers in 1957 including workers employed directly or indirectly in production for export markets in the handling and distribution of imported goods and in first-factory processing of imported materials.<sup>3</sup>

### The Composition of External Trade

One of the interesting aspects of United States trade relates to the

<sup>3</sup> See United States Department of Commerce "Role of Foreign Trade in the United States Economy" *Statistical Reports* Washington, D. C. United States Government Printing Office, November 1957, p 1.

secular change in the composition of its merchandise exports and imports. This change is due to a shift in the economy from a raw material to an industrial goods producer.

*The composition of exports.* Exports and imports are frequently divided into five economic classes: crude materials, crude foodstuffs, manufactured foodstuffs, semi-manufactures and finished manufactures. The greatest shifts in the composition of United States exports have been in the crude materials and finished manufactures categories as shown in Table 11.3. Over one-half of the value of its exports has been in the form of finished manufactures for many years now. In 1820, the earliest date for which reliable foreign trade statistics are available,

TABLE 11.3

UNITED STATES MERCHANDISE EXPORTS BY ECONOMIC CLASSES  
FOR SELECTED YEARS  
(in millions of dollars)

Year	Total value	PER CENT OF TOTAL				
		Crude materials	Crude foodstuffs	Manufactured foodstuffs	Semi- manufactures	Finished manufactures
1960	20,300	12.7	8.1	5.5	17.4	56.3
1950	10,142	18.7	7.5	6.3	11.1	56.8
1940	3,934	11.8	1.8	4.2	22.9	59.2
1930	3,781	21.9	4.7	9.6	13.8	50.2
1920	8,080	23.3	11.4	13.6	11.9	39.7
1910	1,710	33.8	6.4	15.1	15.7	29.2
1900	1,371	24.8	16.5	23.3	11.2	24.2
1890	845	36.6	15.6	26.7	5.4	15.7
1880	824	29.5	32.3	23.4	3.5	11.2
1870	377	56.8	11.1	13.5	3.7	14.9
1860	316	68.7	3.8	12.3	4.1	11.3
1850	135	62.2	5.9	14.8	4.4	12.6
1840	112	67.9	4.5	14.3	4.5	9.8
1830	59	62.8	5.1	16.9	6.8	8.5
1820	52	59.6	3.8	19.2	9.6	5.8

Source. 1820-1950, computed from U. S. Department of Commerce, *Historical Statistics of the United States Colonial Times to 1937* Washington: 1960, pp. 544-545, 1960, U. S. Department of Commerce, *Statistical Abstract of the United States 1961* Washington 1961, p. 888

only about 6 per cent of exports was in the form of finished manufactures. The increasing importance of this type of export is primarily the outcome of the economic growth of this country and increasing efficiency in the production of manufactured goods.

Industrialization was encouraged in the United States at an early stage through the imposition of protective tariffs. The United States also possessed an abundance of natural resources and received much capital

from foreign countries. In addition, the productive capacity of many other industrial countries incurred severe damage during both World Wars while the United States was one of the few countries able to produce finished manufactures during these periods.

A marked change in the proportion of crude material exports has also occurred. This type of export provided well over half of the foreign exchange earnings of this country for many years prior to the Civil War, but now accounts for only slightly more than 10 per cent of these receipts.

Crude and manufactured foodstuffs have remained among the less important types of merchandise export since the 1930's. The United States has had a surplus of foodstuffs, especially since the end of the Korean conflict, but foreign markets for the surplus have not been adequate to absorb them.

*The composition of imports.* The composition of United States imports for selected years since 1830 is presented in Table 11.4. The volume of imports has been more evenly distributed in recent years among each of the five different categories than was the case with exports. Furthermore, the composition of imports, with the exception of finished manufactures, has not changed as much as that of exports.

Crude and manufactured foodstuffs have constituted about one-fourth of the value of all merchandise obtained from abroad in recent years. To a great extent these imports consist of tropical and semi-tropical commodities which cannot be economically produced domestically such as bananas, cane sugar, coffee, cocoa and tea. Coffee in some years has been the leading commodity import in terms of total value. Crude materials have constituted about one-third of the value of all imports since the turn of the century.

For many recent years, finished manufactures have represented less than one-third of the total value of merchandise imports whereas this category of exports accounted for almost two-thirds of the value of all goods shipped abroad. The United States was a net exporter of raw materials and a net importer of manufactured goods during its early stages of growth. Since the turn of the century this country has maintained a deficit position in raw materials and a surplus in manufactured goods.

The trend of imports of finished manufactures for the period 1950-1960 is unusual. In 1950, imports of this type constituted about 17 per cent of the value of all imports. In subsequent years these imports showed an upward trend, and during 1959 and 1960 they represented about one-third of the total. In absolute terms, the value of finished manufactures increased from about \$1.5 billion to slightly more than \$5 billion during 1950-1960. This movement reflects the economic recon-

**TABLE 11.4**  
**UNITED STATES MERCHANDISE IMPORTS BY ECONOMIC CLASSES**  
**FOR SELECTED YEARS**  
**(in millions of dollars)**

PER CENT OF TOTAL

Year	Total value	Crude materials	Crude foodstuffs	Manufactured foodstuffs	Semi-manufactures	Finished manufactures
1960	14,652	20.6	11.8	10.7	21.1	35.9
1950	8,743	28.2	20.0	10.3	24.3	17.2
1940	2,541	39.8	11.2	10.9	22.0	16.1
1930	3,061	32.7	13.1	9.6	19.9	24.7
1920	5,278	33.8	11.0	23.5	15.2	16.6
1910	1,557	37.1	9.3	11.7	18.3	23.6
1900	850	33.2	11.6	15.6	15.8	23.9
1890	789	22.8	16.2	16.9	14.9	29.3
1880	668	21.3	15.0	17.7	16.6	29.5
1870	436	13.1	12.4	22.0	12.8	40.0
1860	354	11.3	13.0	16.9	9.9	48.6
1850	174	7.5	10.3	12.1	15.0	54.6
1840	98	12.2	15.3	15.3	11.2	44.9
1830	63	7.9	11.1	15.9	7.9	57.2

*Source* 1830-1950, computed from U. S. Department of Commerce *Historical Statistics of the United States Colonial Times to 1957* Washington 1960, pp. 544-545, 1960, U. S. Department of Commerce *Statistical Abstract of the United States 1961* Washington 1961, p. 888

struction of Western Europe and the ability of producers in that area to compete in United States markets. Much of the increase in imports of finished manufactures has been in automobiles and various types of machinery.

*The basis for trade* According to modern economic theory, international cost differences arise because of the relatively unequal factor endowments of the various trading regions. A region exports commodities which embody relatively abundant factors of production and imports those which utilize relatively scarce factors. Transportation costs affect international trade, generally reducing the volume of items which are bulky relative to their unit value. The level of national income influences both the volume and composition of trade, and trade restrictions alter the volume, composition and direction of trade.

The industrial development of the American economy, the high per capita income and the use of trade restrictions are reflected in its exports and imports. This country is today an exporter of finished manufactures, of new vehicles, machinery and equipment. These items are the product of a well-educated population and a skilled labor force. They are also the product of a large body of scientists, engineers and others who have pioneered in new fields, who have sought to find better

ways of doing things and who have created new products. To a great extent, trade with other nations reflects the heavy investment of the United States economy in human and capital resources.

### The Direction of External Trade

An interesting aspect of the merchandise trade of the United States is the gradual shift in markets for exports and sources of imports. This direction of trade according to geographical area is closely related to the commodity composition of trade. Trends in the direction and composition of trade are the result of commercial policies of different nations, changes in consumer income and demand, population growth, the discovery and use of natural resources and developments in technology, among other things.

*Direction of trade. exports* The direction of export trade of the

TABLE 11.5

DISTRIBUTION OF UNITED STATES MERCHANDISE EXPORTS BY GEOGRAPHICAL AREAS  
FOR SELECTED YEARS  
(in millions of dollars)

Year	Total value	PER CENT OF TOTAL				
		Other American countries	Europe	Asia	Australia and Oceania	Africa
1959	15,779 <sup>a</sup>	47.3	29.1	17.3	2.0	4.3
1950	9,642 <sup>a</sup>	49.4	30.0	15.6	1.4	3.6
1940	4,021	37.3	40.9	15.4	2.3	4.0
1930	3,843	35.3	47.9	11.7	2.8	2.4
1920	8,228	31.0	54.3	10.6	2.1	2.0
1910	1,745	27.4	65.1	4.5	1.9	1.0
1900	1,394	16.3	74.6	4.9	3.0	1.4
1890	858	15.5	79.7	2.3	1.9	.6
1880	836	11.1	86.0	1.4	.8	.6
1870	471	16.8	80.9	.9	1.1	.4
1860	334	20.7	74.6	2.4	2.4 <sup>b</sup>	.4
1850	144	20.8	75.7	2.1	1.4 <sup>b</sup>	.4
1840	124	24.2	74.2	.8	.8 <sup>b</sup>	.4
1830	72	32.0	66.7	1.4	—	—
1821	55	27.3	65.5	3.6	—	—

<sup>a</sup> Values do not show total merchandise exports for these years. For security reasons, data for a relatively small amount of exports to particular continents are not available.

<sup>b</sup> For the years 1840-1860, exports to Australia, Oceania and Africa are combined.

Source: 1821-1950, computed from U. S. Department of Commerce *Historical Statistics of the United States Colonial Times to 1957*, Washington 1960, pp. 550-551, 1959, U. S. Department of Commerce *Statistical Abstract of the United States 1960*, Washington 1960, p. 894.

United States with other major trading areas for certain years since 1821 is shown in Table 11.5. Probably the most striking change in the direction of merchandise trade has been the decline in the proportion of United States commodities shipped to Europe. Europe, which provided a market for over three-fourths of American exports during the late nineteenth century, presently accounts for less than a third.

The increasing relative importance of other western hemisphere countries, Asia and Africa as markets for United States exports has tended to offset the decline in European markets. With the exception of Canada, these other countries are substantially less developed than the United States and Western Europe. The underdeveloped areas of the world are primarily raw material producers, accordingly there exists a high degree of complementarity of the production of these economies with that of the United States. Latin American markets, for example, since 1951 have become about as important as those in Europe for United States products.

International trade does not consist solely of merchandise exchanges between pairs of countries producing primary goods and finished goods. To the extent that world trade is multilateral in nature, the export balance of one country with a second may offset an import balance against a third country. Complementary production in many commodities prevails among industrialized countries as well as with the less-developed. A large share of world commerce originates in the economically advanced and high income countries because high per capita incomes are one of the more influential determinants of the volume of trade.

*Direction of trade: imports.* As a counterpart of the relative shift in export markets, sources of United States imports have also changed over the years. Europe supplied over half of the value of American imports prior to World War I but now provides substantially less of the total as Table 11.6 shows. The volume of trade between these two areas is influenced by two major counteracting factors. First, the fact that their production lacks the degree of complementarity characteristic of that of the United States and Latin America reduces American trade with Europe. The second, and offsetting, factor is the high income and demand in the United States and Europe which influence a larger volume of transactions between the two regions.

Other American countries have become relatively more important as sources of United States imports, especially Canada. The proportion of imports from Latin America has remained fairly constant since the 1870's despite the fact that this region has become a principal export market for the United States.

Although the United States is becoming slightly more important as a market for products from Africa, the volume of goods purchased from that continent is still not significant. It is unlikely that trade between these two areas will expand greatly in the foreseeable future. Because of its geographical location, Western Europe which formerly procured a substantial volume of primary commodities from Latin America is now obtaining a greater share of these commodities from Africa. In addition, many of the African regions either participate in the Imperial Preference System or are associated with the European Economic Community, and their trade is tied more closely to countries other than the United States.

TABLE 11.6

SOURCES OF UNITED STATES MERCHANDISE IMPORTS BY GEOGRAPHICAL AREAS  
FOR SELECTED YEARS

(in millions of dollars)

Year	Total value	PER CENT OF TOTAL				
		Other American countries	Europe	Asia	Australia and Oceania	Africa
1959	15,212	46.5	30.3	17.1	2.2	3.9
1950	8,852	57.2	15.7	19.2	2.3	5.6
1940	2,625	41.5	14.9	37.4	1.3	5.0
1930	3,061	39.0	29.8	28.9	1.1	2.2
1920	5,278	46.0	23.3	26.5	1.5	2.8
1910	1,557	32.3	51.8	13.5	1.3	1.1
1900	850	26.4	51.9	17.2	3.4	1.3
1890	789	30.2	57.0	10.3	2.2	.4
1880	668	31.7	55.5	11.1	1.0	.6
1870	436	35.1	55.3	8.5	.5	.7
1860	354	29.4	61.3	8.2	1.1 <sup>a</sup>	.
1850	174	21.9	71.3	6.3	.6 <sup>a</sup>	.
1840	98	25.5	64.6	10.2	1.0 <sup>a</sup>	.
1830	63	27.0	63.5	7.9	1.6 <sup>a</sup>	.
1821	55	27.3	63.6	9.1	.	.

\* For the years 1830-1860, imports from Australia, Oceania and Africa are combined.

<sup>a</sup> Less than \$ 5 million

Source 1821-1950, computed from U. S. Department of Commerce *Historical Statistics of the United States Colonial Times to 1957* Washington 1960, pp. 552-553, 1959, U. S. Department of Commerce *Statistical Abstract of the United States 1960* Washington 1960, p. 894.

**Direction of trade: other aspects** The changing direction of United States trade stems from a number of factors. This country has evolved from an agricultural and raw material producer to a highly industrialized nation. Numerous countries have passed through similar stages

while others exhibit little evidence of economic development or have not advanced as rapidly as this country. As the United States achieved a high degree of efficiency in the production of new and different commodities, profitable export markets for consumer and investor goods were sought and obtained. In addition, its import needs changed as a result of an increased demand for industrial raw materials and a variety of consumer goods.

A shift in the composition of trade frequently leads to a change in the shares of imports supplied by the different regions. When the United States became a net exporter of finished manufactures, imports from other industrialized areas, especially Western Europe, became relatively less important.

According to one study covering the years 1928-1956, the direction of international trade has been influenced significantly by regional groups which maintain political control over their payments.<sup>4</sup> These groups include the Sterling Area, the European Payments Union and the Dollar Bloc.<sup>5</sup> Payments for imports have been easier within the regions than across their boundaries. These regional monetary groups have forced trade into certain channels. Trade has become increasingly important between the United States and Canada and parts of Latin America as a result of the Dollar Bloc.

*Future trends in foreign trade* Projections of future markets and sources of imports for United States business firms are hazardous because they depend on a variety of unpredictable political and economic circumstances.<sup>6</sup> The geographic location of markets and the composition of exports depend upon such factors as the extent of regionalism in Western Europe and Latin America, economic expansion in low-income countries, developments in the cold war and technological improvements in production, to mention but a few. If the United States and Canada were to join in a common market arrangement, trade with Canada, already at a high level, would quite likely become even more important. A change in the nature of the domestic farm program might also have a significant impact on the composition and direction of trade. A shift in consumer tastes influences the composition of trade. Automobiles, one of the leading types of American exports, provide a good illustration. As a consequence of a change in consumer tastes, the com-

<sup>4</sup> See Thorbecke, Erik *The Tendency Towards Regionalization in International Trade 1928-1956* The Hague: Martinus Nijhoff, 1960, pp. 170-215.

<sup>5</sup> The Dollar Bloc, it should be noted, is not a zone or area.

<sup>6</sup> The unpredictability of future trade can be illustrated by the case of Cuba. A large share of Cuba's trade was with the United States until 1960. Since then, commerce between these two countries has declined sharply.

compact and more economical foreign automobile became a major import, reaching its peak in 1959. This type of import declined in 1960, presumably because of the subsequent appearance of the American compact car.

### Other Characteristics of External Trade

The volume of external commerce, especially import trade, is closely related to changes in the level of economic activity in the United States and is strongly influenced by both cyclical and secular movements in national output.

*Trade and the business cycle* Trade tends to decline during periods of domestic recession and to expand during recovery and prosperity. A rising level of production, employment and income normally results in increased demand for domestic and imported goods and services. A declining level of business activity and income induces a contraction in the demand for domestic and imported commodities. One study of American imports since the Civil War indicates that there is a direct relationship between the business cycle and imports.<sup>7</sup> The same study concludes that imports have fluctuated more widely both in terms of value and quantity than domestic production in all major business cycles since the Civil War.

The volume of trade depends not only upon the level of business activity in the United States, but also upon that in foreign countries. Developments abroad serve either to offset or to accentuate domestic influences on foreign trade. However, because of the magnitude of the American economy, domestic developments generally tend to be the dominant factors.

The tendency for United States imports to decline in conjunction with domestic recession has a strong impact on many foreign economies. Most countries which export to the United States are smaller than this country, and their economies are more closely geared to external commerce. Accordingly, a slight decline in United States imports may have a disruptive effect on the balances of payments of many smaller nations. Continued prosperity in the United States is probably one of the essential conditions for accelerating economic growth in low-income countries. A high and stable level of employment in this country induces a large volume of imports, thus providing a part of the foreign exchange receipts required by developing areas.

*Secular growth and United States trade.* Another characteristic of international trade is that it has shown an upward trend following the expansion of production. Increasing income and demand induce a high-

<sup>7</sup> Humphrey, Don D. *American Imports* New York: The Twentieth Century Fund, 1955, pp. 39-71.

er volume of trade. Better transportation and communication systems have also stimulated commerce among nations.

Although the external trade of the United States is expanding, statistical evidence indicates that it has not grown quite as rapidly as its gross national product. The ratio of trade to national product has fluctuated widely in the short-run, but it appears to have declined slightly on a secular basis. In the late 1800's the value of exports and imports each ranged from about 6 to 8 per cent of gross national product, in the 1950's exports varied from 4 to 5 per cent and imports about 3 per cent of the gross national product. This primarily reflects the fact that, as the United States advanced economically, domestic production became more diversified. The United States agricultural sector produces a greater volume of food products than that needed for domestic consumption and its manufactures are more than sufficient in many lines to serve domestic requirements. Accordingly, it became less dependent upon the rest of the world as it became more advanced. Essentially, its dependence upon the rest of the world is limited to certain strategic materials and to foodstuffs which contribute to the variety in consumer diets.

The failure of trade to expand as rapidly as gross national product is partially a result of the development of various synthetics which serve as substitutes for imported goods. Synthetic rubber replaces natural rubber for many purposes. Raw silk, one of the leading imports in the pre-World War II period, has been replaced by man-made fibers for many uses. In some cases the development of synthetics has altered the composition, but not necessarily the volume, of trade.

Another factor which has prevented trade of the United States from expanding as rapidly as its gross national product is the existence of tariffs, quotas, and other impediments to international commerce. This country, like many others, has curbed the volume of imports but it usually has not placed restrictions on domestic production. A greater volume of commodities would be obtained from external sources if these barriers did not exist.

### Services

The second category in the current account consists of the various types of services rendered to and received from foreigners. These include transportation, travel, returns on capital investment and miscellaneous services. For obvious reasons, the service accounts are frequently termed "invisible" items of trade. A summary of United States service accounts for the period 1950-1960 is shown in Table 11.7. The items presented in this Table do not include military expenditures abroad and therefore are primarily of a commercial nature. As was true

in the case of merchandise trade, this country's earnings from services have been greater than its expenditures for them. Receipts exceeded payments by slightly more than \$2 billion a year on the average during this period.

**Transportation.** Payments and receipts for transportation are among the more important of the service items. This account includes revenue and disbursements incurred in the international movement of goods and persons. The expenses incurred for transportation are directly related to the volume of international trade.<sup>8</sup> During the period 1950-1960, transportation receipts provided about 26 per cent of all service receipts and transportation payments accounted for about 35 per cent

TABLE 11.7

UNITED STATES SERVICE RECEIPTS AND PAYMENTS, 1950-1960  
(in millions of dollars)

Type of service account	Receipts		Payments		Balance on service account <sup>a</sup>
	Value	Per cent of total	Value	Per cent of total	
Transportation	16,641	25.6	14,532	34.8	+2,109
Travel	7,450	11.5	12,903	30.9	-5,453
Investment returns	26,546	40.8	6,129	14.7	+20,417
Miscellaneous	14,395	22.1	8,240	19.7	+6,155
Total	65,032	100.0	41,804	100.0 <sup>b</sup>	+23,228

<sup>a</sup> (+) indicates surplus, (-) indicates deficit

<sup>b</sup> This total is not equal to the sum of the items because of rounding

**Source** Computed from *Exports, Imports, and the United States Balance of International Payments: A Study by the Legislative Reference Service of the Library of Congress*. Senate Document No. 105, Washington, May 1960, p. 44, and *Survey of Current Business*, U. S. Department of Commerce, July 1961, p. 22

of all service payments. The United States earned more than it paid for transportation for this eleven-year period although payments slightly exceeded receipts during 1959 and 1960.

The ability of the United States to maintain a surplus on the transportation account during most years has been due in great measure to the government's policy of subsidizing the construction and operation of ocean vessels and to cargo preference or the use of American bottoms for foreign aid shipments. This policy is based primarily on the argument that a large and active transportation industry is essential for national defense. Because of government assistance, American ship-

<sup>8</sup> Transportation expenses could conceivably decline even with expanded world trade especially if trade between contiguous areas increased, and decreased between distant areas. Technological developments in transportation might also reduce costs.

ping concerns have been able to absorb a greater share of the world shipping than what would otherwise be the case.

*Travel.* Travel represents another important source of receipt and payment in the service accounts. United States receipts for travel include the personal expenditures of foreign residents in this country and its payments cover similar expenditures of American residents in foreign countries. As shown in Table 11.7 this country's travel receipts provided almost 12 per cent of its total service receipts, and travel expenditures constituted about 31 per cent of its total service payments during the eleven-year period. An upward trend in travel expenditures and receipts reflects increased personal incomes, longer vacations, improved transportation facilities, better living accommodations and a larger volume of world commerce.

Unlike many other items in the current account, United States travel payments have exceeded receipts. In other words, the American tourist trade abroad is more important in absolute terms than foreign tourist trade in this country. This import surplus suggests a greater willingness and ability of Americans to travel abroad. The United States government established a Travel Service in 1961 to persuade more foreigners to travel in this country.

The expenditures of Americans in Canada on this account are becoming relatively less important, those in Western Europe and the Mediterranean relatively larger while the proportion spent in other areas has remained relatively constant. Residents of the United States are not only willing to do more traveling, but they are inclined to travel greater distances.

*Payments and receipts on capital investment.* A third source of revenue and expense arises from earnings on American capital in foreign countries and foreign capital in the United States. Receipts accrue as a consequence of the payment of dividends and interest to the United States government and American residents who hold investments abroad. Payments arise when domestic residents remit interest and profits to foreign investors in this country. Payments and receipts on capital investment have accounted for a substantial share of the total disbursements and revenue in the current account since 1950 and are examined in greater detail in chapter 14.

*Miscellaneous service receipts and payments.* In addition to travel, transportation and returns on investment, a wide range of items is included in the miscellaneous service account. They include payments and receipts for such private services as communications, reinsurance, motion picture rentals, certain types of royalties, contractors' services as well as certain types of government service transactions. Because

the value of these *individual* service items is small, they are grouped into a miscellaneous category. In the aggregate, as shown in Table 11.7, they represent an important form of American receipts and payments

## QUESTIONS AND PROBLEMS

1. What have been the most important changes in the composition of merchandise trade of the United States? Account for these changes.
2. The composition and direction of United States trade have changed over the past 150 years. What changes can be expected in the future? Indicate the factors which cause them.
3. "The value of United States exports is equivalent to 5 per cent of national income. Therefore external trade is not important to this country." Comment on this statement.
4. Explain why United States trade with Latin America is more important than trade with Africa.
5. Many foreign countries are concerned lest the United States fail to maintain a high level of employment and income. Why should these countries be concerned with the domestic affairs of the United States?
6. Indicate the various factors which are conducive to a high level of merchandise trade between countries.
7. Some persons suggest that in the interests of national security, the United States should reduce its imports and become more self-sufficient. Can the United States become completely self-sufficient? Would it be desirable to become less dependent upon other countries? Why or why not?
8. Travel payments have exceeded travel receipts in the United States current accounts for many years. What could the United States government do to increase these receipts? Could they be increased to equal travel payments without restricting the travel of Americans abroad? Why or why not?

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## Unilateral Transfers

"It is logical that the United States should do whatever it is able to do to assist in the return of normal economic health in the world, without which there can be no political stability and no assured peace. Our policy is directed not against any country or doctrine but against hunger, poverty, desperation and chaos. Its purpose should be the revival of a working economy in the world so as to permit the emergence of political and social conditions in which free institutions can exist. Such assistance, I am convinced, must not be on a piecemeal basis as various crises develop. Any assistance that this Government may render in the future should provide a cure rather than a mere palliative. Any government that is willing to assist in the task of recovery will find full cooperation, I am sure, on the part of the United States Government."

This statement was made in 1947 by Secretary of State George C. Marshall. Through Lend-Lease operations of previous years, the United States government assisted the Allied countries in Europe in the campaign against the totalitarian powers. It committed itself to aid economic recovery in the aftermath of that campaign through the Marshall Plan which emerged subsequent to Secretary of State Marshall's speech.

Most United States government assistance took the form of loans during the early part of this century and through the first World War. Because of the defaults on many of these loans, since the beginning of World War II emphasis shifted toward the use of unilateral transfers as a substitute for government loans. However, there was a movement back to the use of loans in 1958 and subsequent years.

### The Nature of Unilateral Transfers

*Private unilateral transfers.* The smallest component of total unilateral transfers is that represented by the gifts of private residents and institutions. A variety of circumstances prompt this type of transfer of domestic purchasing power, goods and services to foreigners. Immigrants

frequently send remittances and merchandise to their families or friends abroad. Religious groups make funds available for the establishment and maintenance of missions abroad. Such groups as CARE and the American Red Cross provide emergency assistance overseas. Other charitable, educational and scientific organizations supply funds overseas for hospitals, education, research, food, medicine and clothing. Private transfers have been overshadowed by government unilateral transfers, which have increased substantially since the beginning of World War II. Table 12.1 shows total unilateral transfers, both government and private, for selected years since 1945.

*Government unilateral transfers.* Government unilateral transfers include such aid programs of the United States as Lend-Lease, UNRRA, Interim Aid, the European Recovery Program, Technical Assistance Programs and some of the Mutual Security Programs.<sup>1</sup> Another type of government unilateral transfer includes reparation payments to or from foreign governments.

Usually no repayment is anticipated with government unilateral transfers. However, the recipient of such transfers may be expected to cooperate in the achievement of common objectives. United States assistance is sometimes extended on the assumption that terms of repayment will be established at a later date and is initially classified as a grant or unilateral transfer. Only when an arrangement for repayment is concluded is the transaction classified as a loan.

*Government unilateral transfers versus loans.* A large share of United States foreign assistance has been in the form of government loans, and sooner or later a borrowing country must make repayment. Loans may eventually impose a strain on the balance of payments of the recipient country. Grants are advocated in instances where the repayment of a loan would impose a burden on the economic capacity and balance of payments of the recipient country. Loans are feasible if the recipient country possesses the capacity to meet future interest and amortization obligations or when they serve to increase this capacity. Grants which do not impose a strain on the balance of payments have become the principal form of United States foreign assistance since the beginning of World War II.

*Background for the changed composition of government assistance.* The influences which motivated the grant type of foreign assistance can be traced to World War I. During this war, the Allies were compelled to

<sup>1</sup> There is little agreement on the definition of foreign aid. Some maintain that it should be defined to include long-term government loans, those repayable in local currency as well as government grants. Others insist that it should be defined to include government short-term loans. The form of foreign aid emphasized in this chapter is that of government unilateral transfers. These are termed donations or transfers by the International Monetary Fund.

TABLE 12 1

UNITED STATES UNILATERAL TRANSFERS FOR SELECTED YEARS  
(in millions of dollars)

Year	Total unilateral transfers (net)	Private remit- tances (net)	Government unilateral transfers (net)
1945	7,113	473	6,640
1950	4,544	455	4,089
1955	4,811	444	4,367
1956	4,977	530	4,447
1957	4,753	543	4,210
1958	4,619	540	4,079
1959	4,398	575	3,823
1960	4,254	633	3,621

Source. Data obtained from issues of *Statistical Abstract of the United States*, United States Department of Commerce, Washington, and *Survey of Current Business*, Department of Commerce, Washington, July 1961, p. 22.

sell much of their holdings of American securities in order to buy United States goods. In addition, the United States government extended about \$7 billion worth of credit, an amount which was increased by about \$3 billion in the early post-war period.

Although government loans to European countries were for an emergency purpose, they were regarded by both the people and the Congress of the United States as commercial transactions, subject to regular interest payment and amortization. It became increasingly evident during the twenties that the settlement of these obligations imposed a burden on the debtor nations, and they urged more favorable terms of repayment. To repay the debts, they had to obtain additional dollars through a surplus on their current account with the United States or by an increased inflow of investment funds from this country. Some of the Allies desired to tie their obligations to the United States to reparation payments from Germany, a proposal which was unacceptable.

Although the United States continued to exact repayment of the war debt, it was unwilling to accept the role of creditor nation. The government in the mid-twenties liberalized the terms of repayment by reducing interest rates and extending the maturities of the loans. These concessions were partially neutralized by this country with the introduction of more restrictive trade barriers which made it increasingly difficult for debtor nations to earn dollars. The Fordney-McCumber Tariff Act of 1922 raised the tariff substantially, and the Hawley-Smoot Tariff of 1930 imposed the highest duties ever witnessed in the history of the United States. American business interests viewed with reserve the possible inflow of imports to liquidate the debt. Furthermore, United

States capital outflow was inadequate to enable the debtor nations to earn enough dollars for the settlement of their obligations.

Because of the depression, financial crises and mass defaults on public and private loans, the government announced a temporary moratorium on inter-governmental debt repayments in 1931. Most European countries, with Finland a notable exception, defaulted either wholly or partially on their obligations to the United States in the ensuing period. Nevertheless, American pressures for the resumption of repayments persisted and culminated in the Johnson Act of 1934 which prohibited the extension of public or private credit to governments which had defaulted on their obligations to the United States.<sup>2</sup> As a result American prestige abroad declined. The animosity created by both debtor and creditor nations reinforced American isolationism which persisted until the late thirties when the Axis war machine threatened Europe.

The large volume of United States government unilateral transfers, which served as a partial substitute for inter-governmental loans, reflected several factors. First, loans originating under emergency conditions frequently impose a burden on the balance of payments position of debtor nations. Second, creditor nations, though insisting upon full settlement of loans, may be unwilling to accept an import balance and the consequent downward pressure on domestic employment and production. Third, unilateral transfers stem from a recognition that the plight of one or a few Allies cannot be borne alone and that the collective security and the combined strength of such countries is a foremost objective. Collective security requires a mutual sharing of the costs of economic and political strength and solidarity. This philosophy, as implied in the title of one of the major foreign assistance programs since 1951, the Mutual Security Act, still dominates American thinking.

### World War II Assistance

The outbreak of World War II prompted the United States to furnish its Allies with supplies and equipment needed for waging the war. Certain neutral nations were supplied with materials essential to their stability and security. The largest volume of assistance was channeled through Lend-Lease operations, although a relatively small amount was handled through the United Nations Relief and Rehabilitation Administration.

*Lend-Lease.* The Lend-Lease Act, approved early in 1941, author-

<sup>2</sup> The prohibition on loans to countries which had failed to discharge World War I obligations was not changed until 1945 when the Bretton Woods Agreements Act authorized United States participation in the World Bank and the International Monetary Fund.

ized the President of the United States to make defense items available to countries engaged in conflict with the Axis powers. To conduct a successful campaign the Allied nations needed a wide variety of commodities, a sufficient volume of which could neither be produced domestically nor imported through usual commercial channels. Of necessity, the United States became the major supplier of materials essential for the war effort. Shortly after its initiation, the Lend-Lease Program was providing the financing for over one-half of the total value of United States exports.

The Lend-Lease items made available to Allied nations were divided into two basic groups—those which had value primarily as weapons of war, and those which were either civilian-type supplies or those which might be employed after the war for peace-time purposes. The former, which included specialized types of military equipment and ammunition, were partially or completely destroyed during the conflict and no repayment was expected for them. Any articles of this nature remaining intact at the termination of hostilities could have been reclaimed by the United States. The second type, which could be utilized for peace-time production, was sold to friendly nations with settlement to be arranged at the close of the war.

A Reverse Lend-Lease Program whereby the Allies provided certain goods and services, notably food and living quarters, to United States military and civilian personnel stationed abroad was instituted at the same time. This Program represented an endeavor by the Allies to pool available resources in an optimum fashion for military objectives.

The total value of Lend-Lease shipments through October 1945, at which time these operations were virtually terminated, was about \$45 billion. Approximately 94 per cent of the volume was assigned to the British Empire and the U.S.S.R. The remainder was furnished to Belgium, Canada, China, Egypt, France and the Latin American republics. Reverse Lend-Lease, most of which was obtained from the British Empire, amounted to slightly more than \$6 billion.<sup>3</sup> Final settlements of these transactions with all but one of the Allies were concluded shortly after the war. Attempts to reach an agreement with the Soviet Union have been unsuccessful.

**UNRRA.** With the inception of the United Nations Relief and Rehabilitation Administration (UNRRA) in 1943, the United States participated with forty-three other nations in a multilateral organization for the distribution of aid. These countries, with the exception of those which had been invaded by the enemy, provided an amount equal to 1

<sup>3</sup> See *Twenty-First Report to Congress on Lend-Lease Operations* Government Printing Office, Washington, D C 1946, pp. 11 and 14

munist subversion, a large share of United States aid has been directed toward this area since the beginning of the Korean Conflict.

*Interim Aid.* In view of the critical need for food, fuel and fertilizers in certain regions, the United States launched the Interim Aid Program in 1947. Under this Program, emergency grants totaling almost \$600 million were provided to France, Italy, Austria and China. These areas had depleted their foreign exchange reserves and would have faced internal disorder unless the situation was alleviated. Interim Aid was a temporary arrangement designed to continue the flow of goods and services until the European Recovery Program could assume the burden.

### Post-War Reconstruction and Development

A large share of immediate post-World War II assistance was of an emergency nature, and it was not until the Marshall Plan and the Point IV Program were initiated that economic reconstruction and development were stressed. Because of their nature and size, these two programs are unparalleled in American history.

*Basis for Marshall Plan aid.* The assistance extended by the United States to Western Europe in the immediate post-war period was sporadic and insufficient. Because it was provided primarily for the purpose of alleviating impending disaster, the resulting benefits were of a temporary nature. Lend-Lease ended soon after the termination of hostilities in Europe, and by 1947 it became apparent that existing programs were not directed toward a solution of the basic problems. In 1947 the United States proposed a systematic effort, the European Recovery Program or the Marshall Plan, to accelerate the economic reconstruction of Europe.

*Nature of the Marshall Plan.* The Marshall Plan, which might be termed a successor to the Lend-Lease program reflected the need for large-scale coordinated assistance. Through this Plan it was felt reconstruction could be conducted on a regional basis and be carried out with speed and efficiency. As suggested by Secretary of State George C. Marshall, after whom the Plan was named, future assistance ". . . should provide a cure rather than a mere palliative." The Plan was to be a concerted endeavor to revive the war-torn economies, promote recovery in production and trade and foster internal stability. Program emphasis was to be shifted from relief to recovery. Participating nations were to initiate individual as well as cooperative programs and the whole effort was to be largely financed by United States grants and aid.

The offer by the United States to render assistance induced an immediate and favorable response from sixteen countries of southern and western Europe.<sup>4</sup> The U.S.S.R. not only declined to participate in the cooperative arrangements, but successfully exerted pressure upon the satellites to do likewise.

The essence of the Plan was that each recipient government would draw up a reconstruction plan which included the projects to be undertaken, the total resources needed and the resources available locally. The United States was to furnish the difference between the total amount needed for the restoration of productive capacity and the amounts which the countries could provide for themselves. Under the newly-established Organization for European Economic Cooperation (OEEC), the plans of individual nations were to be integrated into an over-all program of recovery. In the United States, the Economic Cooperation Administration (ECA) was created to implement and administer the operations.

The coordination of plans was designed to facilitate a number of objectives. First, extensive duplication of productive facilities within the European community was to be avoided. It was also expected that the association would foster cooperation and economic harmony among member countries during and beyond the existence of Marshall Plan aid. The OEEC was the parent body for the European Productivity Agency, the European Payments Union and the European Monetary Agreement. It also sponsored efforts to create a successor organization, the Organization for Economic Cooperation and Development (OECD), which additionally includes the United States and Canada.

The United States supplied monetary resources through the Marshall Plan to Western Europe but it did not direct the actual procurement of physical resources. Participating governments were free to use the dollars to purchase items in world markets but about two-thirds of the volume of goods and services were obtained from this country.

*Counterpart funds.* The legislation which embodied the European Recovery Program required the recipient country to accumulate local currency deposits, or counterpart funds, equal to the sales value of products received under the Program. The United States retained 5 per cent of the counterpart funds for the purchase of materials in which it was deficient and for other local currency requirements. The remaining funds were utilized by host countries, with the agreement of the

<sup>4</sup> The sixteen nations were Austria, Belgium, Denmark, France, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Sweden, Switzerland, Turkey and the United Kingdom.

United States, as a form of secondary assistance usually for investment purposes.<sup>5</sup>

*The cost and success of the Marshall Plan.* From the inception of the European Recovery Program through June 1951, at which time the operations were almost completed, the United States provided approximately \$10.3 billion in grants and credits. Credits, which accounted for about 11 per cent of the total, were administered by the Export-Import Bank of Washington.

The European Recovery Program has generally been considered a success for it accelerated and restored European productive capacity. As a result, these nations were in a better position to participate in world trade, to maintain domestic stability and to join the rest of the free world in opposition to Communist aggression. The Plan instilled a spirit of cooperation among these countries which has extended beyond the duration of the Recovery Program.

*Basis for the Point IV Program.* At the same time that the European Recovery Program was in operation, attention was focused on conditions in other areas—the underdeveloped countries. In his inaugural address in 1949, President Truman stated that “. . . we must embark on a bold new program for making the benefits of our scientific advances and industrial progress available for the improvement and growth of underdeveloped areas.” This was the essence of the fourth point of his address and the assistance offered as a result of these recommendations was thereafter known as the Point IV Program.

*Nature of the Point IV Program* This Program represented a departure from the European Recovery Program. Unlike the latter, it did not stress the provision of financial resources to needy nations. It reflected a recognition that, in contrast to Western Europe, the major bottleneck to higher productivity in the underdeveloped areas was not simply a shortage of resources which could be procured from the United States. The underdeveloped areas appeared to need information and guidance on ways to use their local resources more fully and effectively. The problem in Western Europe was to rebuild productive capacity and to restore economic growth, in the underdeveloped countries it was to create productive capacity and to initiate economic growth. Point IV operations consequently supplied underdeveloped countries with more advanced technology. The assistance stressed demonstra-

tions which showed how the level of production in agriculture could be increased and public sanitation and health improved.

The Point IV proposal was embodied in the International Development Act of 1950 which authorized the government to supply information, technology and knowledge to underdeveloped areas and which was applicable to a wide range of activities. The technical knowledge imparted to areas of Latin America, Africa, the Middle and Far East was supported by a relatively modest budget. The philosophy was that the scale of living and the level of productivity in such areas could be raised through changes in methods which could be implemented with but little new capital. Teams of technicians and professional staffs were sent abroad under the Program to demonstrate and to teach the inhabitants new methods in agriculture, industry, housing and health. Technicians from these countries were trained in the United States and upon return to their homelands disseminated the information and knowledge which they had acquired.

### The Mutual Security Program

Since the end of the Marshall Plan, the emphasis of foreign assistance has shifted from Western Europe to the underdeveloped regions of Africa, Asia and Latin America. As the aid program moved to new locations the character of the aid became crystallized, a condition which can be attributed to two factors. First, the Korean Conflict and the increasing hostility of the Communist Bloc served to focus attention on the military requirements of Allied nations. Second, and reflecting the philosophy of the Point IV efforts, the needs of the underdeveloped areas are too complex to be satisfied by dollars. A healthy political climate and a higher rate of economic growth in these regions require assistance to supplement dollar aid, primarily a wide range of technical assistance.

A large share of United States unilateral transfers has been coordinated and conducted under the Mutual Security Program (MSP) since 1951. The Mutual Security Act, which replaced the Mutual Defense Act of 1949, authorized additional dollar assistance for either military or economic support of the programs of the cooperating nations. The essential purpose of the MSP was to foster the military potential and the economic welfare of friendly nations.

As shown in Table 12.2 a variety of operations has been conducted under the MSP. Most of the provisions of the Mutual Security Acts were replaced by the foreign aid program instituted in 1961, which added certain new provisions and retained many features of the MSP.

Part of the assistance extended through Mutual Security appropri-

TABLE 12.2  
MUTUAL SECURITY APPROPRIATIONS, FISCAL YEAR 1960  
(in millions of dollars)

Purpose	Amount
Military Assistance	1,300
Defense Support	695
Development Loan Fund	550
Special Assistance	245
Technical Cooperation	181
Contingency Fund	155
Other programs	100
Total	3,226

Source: *The Mutual Security Program, Fiscal Year 1961* Department of State, Department of Defense, International Cooperation Administration and the Development Loan Fund Washington March 1960 P. xvi.

tions has been in the nature of loans rather than unilateral transfers. For example, about 30 per cent of the funds made available in 1959 were in the form of loans, most of which were provided through the Development Loan Fund. The Development Loan Fund, a United States government corporation which administered those Mutual Security funds utilized for long-term financing, is described in chapter 14. Remaining categories of aid under the MSP included Military Assistance, Defense Support, Special Assistance, Technical Cooperation and the Contingency Fund, among others.

*Military Assistance.* In an effort to reinforce the military strength of the United States and friendly nations, this country has provided training, military equipment and supplies under the MSP to about thirty-five countries throughout the free world. Military Assistance to foreign countries is not considered an additional cost to the United States. Although a large volume of aid is appropriated for this purpose, the existence of an external deterrent force enables the United States to devote a smaller amount of its resources for its own domestic defense.

Military support extended by the United States is combined with similar efforts of participating countries. For example, while this country contributes military assistance to the North Atlantic Treaty Organization, the combined resources supplied by other member countries provide most of the total. Military Assistance has been supplied to the countries of the Far and Near East and South Asia, a small amount has been given to Africa and Latin America.

*Defense Support.* Defense Support under the MSP represented economic assistance to certain countries which could not otherwise afford to utilize a sufficient portion of domestic resources for an adequate military force. Economic assistance, by strengthening the pro-

ductive capacity of the recipient country, enabled it to bear a heavier military burden. Each of the countries which received Defense Support was strategically located with respect to Communist territories and most of them were characterized by low levels of productivity and income.

*Special Assistance* Special Assistance was a type of economic aid limited to countries where the United States did not provide military assistance in support of substantial defense forces and where aid through Technical Cooperation and the Development Loan Fund was not appropriate. The broad objectives of Special Assistance were the maintenance and promotion of political and economic stability. Activities administered under Special Assistance have been diverse. One of the more significant operations, conducted in cooperation with the World Health Organization, was a world-wide effort to eradicate malaria. Other programs have been instituted under Special Assistance in the fields of health and education.

*Technical Cooperation.* Programs under Technical Cooperation were designed to initiate innovations and increase the skills of people in underdeveloped areas through training, demonstrations and similar activities. This operation was comparable to the Point IV Program, and it was directed toward the achievement of higher standards of living. Some of the specific projects consisted of training personnel to maintain and operate machinery, to achieve higher productivity in agriculture and to prevent disease.

*Contingency Fund* Because it has been extremely difficult to anticipate all needs which arise in underdeveloped areas, a Contingency Fund has been created. The diversity of uses for the Contingency Fund can be illustrated by several examples. In fiscal year 1959, a substantial amount of budget assistance was provided to the government of Jordan from the Fund. During 1958 Chile encountered a severe decline in copper prices, the United States was able to supplement the foreign exchange earnings of Chile, through the Contingency Fund. Resources of the Fund have also been utilized to counteract epidemics—smallpox, cholera and hepatitis—and to meet natural disasters such as floods, earthquakes and hurricanes.

*Other Mutual Security assistance* In addition to specific categories of assistance, several other operations were executed through the Mutual Security Program. One of these is Section 402 of the Mutual Security Act which allocates funds to finance the export and sale of United States surplus agricultural products. Local currency proceeds accumulated from these sales have been used to further the objectives of the MSP. Mutual Security funds have also been appropriated for the Atoms for Peace Program, the United Nations Children's Fund, the Intergovernmental

Committee for European Integration and the United States Escapee Program.

*The Mutual Security Program: conclusions.* Although expenditures for the Mutual Security Program have averaged slightly more than \$4 billion each year, the annual amount allocated has declined since 1953. Military aid has tended to exceed non-military aid since 1952, but it is often difficult to make a sharp distinction between the two categories.

In terms of its initial objectives, that of strengthening the collective security of Allied nations, the Mutual Security Program has provided substantial benefits to both the United States and other participating nations. Because of the diverse nature and flexibility of the programs, it has been possible to tailor the form of aid to fit the needs of particular areas. Through a blending of economic and military aid, the Program has fostered economic and political stability in underdeveloped countries and has provided a foundation upon which a deterrent force has been built.

### The Foreign Aid Program of 1961 and Other Assistance

In 1961 the Congress enacted into law a new foreign aid program (Public Law 87-195). This legislation retains much of the essential nature of the Mutual Security Program including the provision of military funds for friendly nations, Supporting Assistance, a form of economic aid which enables nations with weak economies to budget more funds for economic or military stability and the Contingency Fund, giving the President financial resources to be used for objectives in the national interest.

Another feature of the legislation of 1961 provides for the promotion of economic development in low-income countries. An attempt is also being made to put the aid program on a more permanent basis because it is recognized that economic and social development cannot be achieved in a short period of time and therefore assistance to foreign lands must possess long-range continuity.

The trend toward loans and away from grants in United States foreign assistance is quite pronounced in the implementation of this legislation. Generally, the loan terms are more favorable to recipients than commercial loans. Some permit a fifty-year repayment period, require no interest, and amortization does not commence for a period of ten years. Aid is also offered in the form of grants, but it is directed primarily toward development of social overhead capital in low-income countries. This type of capital, which might be considered investment in human beings, is generally not self-liquidating despite the fact that it is an essential part of economic development. Another feature of the

aid program is that it proposes to induce recipient countries to make a greater effort of their own to achieve development. A large share of aid operations has been coordinated under the new Agency for International Development.

*The trend away from grants.* The large volume of grants extended by the United States to foreign countries does not constitute the entire aid operation. Government loans, which are described in chapter 14, are often included as part of the foreign aid program. The United States also contributes to the four United Nations financial institutions which administer assistance throughout the world, these are considered in chapter 24.

A decreasing share of United States foreign assistance since 1958 has been in the form of grants and an increasing share in loans. This does not imply a trend toward the commercial type loans provided by the government during and shortly after World War I. A large share of the recent loans has been on favorable terms which could not be duplicated in commercial markets. Loans extended by the government are sometimes repayable either partially or wholly in the currency of the recipient country. In certain cases where dollar repayment is expected, the loans are interest free, they are extended for fifty-year periods and an initial grace period of ten years is permitted. Credits of this nature have been made available to some underdeveloped countries which might experience balances of payments difficulties if repayment were exacted on a commercial basis.

### Aid Programs of Other Nations

United States aid is unique in the field of international relations because its volume is greater than that of other countries and because a large share of the total takes the form of grants as opposed to credits. But virtually all other advanced countries have accepted the responsibility of sharing the cost, either unilaterally or multilaterally, of fostering development in other countries. The greatest share of this aid has been provided by France and the United Kingdom.

Assistance from the advanced countries is inspired principally by humanitarian, economic and political factors. The humanitarian motive is noteworthy, and the desire to assist persons in less fortunate circumstances is widespread. The economic stimulus is also significant; as the aid recipients develop, they become better international trading partners, both as sources of materials and as markets for other products. Because the role of the neutral or uncommitted nations is critical in the cold war, perhaps the dominant factor influencing aid is political. Part of the aid provided by other nations of the free world is integrated

through the Colombo Plan and the Development Assistance Committee.<sup>6</sup>

*Colombo Plan.* The foreign aid efforts of several nations are coordinated through the Colombo Plan for Cooperative Economic Development in South and Southeast Asia. Established in 1950 by British Commonwealth countries, with Australia, Canada, Great Britain, Japan, New Zealand and the United States representing the major contributors, the Plan endeavors to coordinate programs of development assistance available to numerous territories in Asia.<sup>7</sup>

A major obstacle confronting the Asian regions is an unprecedented expansion in population, accordingly an attempt is made to ensure that the assistance encourages a productive use of growing populations. Extensive technical assistance and training have been provided, and attention has been focused on raising productivity in the agricultural and raw material sectors. Since its inception, about \$6 billion worth of aid, most of which has been contributed by the United States, has been extended to these territories. Capital assistance given to Colombo Plan countries is extended bilaterally, the organization fosters consultations on the needs of the recipients, evaluates the basic problems, and makes proposals on the most efficient use of aid.

*The Development Assistance Committee.* A Development Assistance Group was created in 1960. Originally it was an informal group of representatives of several advanced nations which convened on irregular occasions to discuss and compare foreign aid programs for low-income countries. With the inception of the Organization for Economic Cooperation and Development (OECD), the Group became a formal committee, the Development Assistance Committee (DAC) which for the most part represents OECD members.<sup>8</sup> DAC will meet regularly and provide a forum for the purpose of discussion and coordination of aid activities. It will review aid programs, act as a clearing house for information and make recommendations concerning the nature

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<sup>6</sup> The Communist Bloc also engages in foreign aid activities. Virtually all of the Bloc's assistance is in the form of long-term loans at relatively low rates of interest. For the period 1954-1960 the Bloc had committed itself to render economic and technical assistance equivalent in value to about \$3.5 billion to 24 non-Communist countries. The United Arab Republic, India and Indonesia have accounted for almost two-thirds of the total. For a summary of Communist Bloc activities, see The President's Task Force on Foreign Economic Assistance, *An Act for International Development: A Summary Presentation* (Washington, June 1961), pp. 185-189.

<sup>7</sup> Recipient territories include Burma, Cambodia, Ceylon, Malaya, India, Indonesia, Laos, Nepal, North Borneo, Pakistan, the Philippines, Sarawak, Singapore, Thailand and South Viet-Nam.

<sup>8</sup> Membership in the DAC includes Belgium, Canada, France, Great Britain, Italy, Japan, the Netherlands, Portugal, West Germany, and the United States. Presumably membership will be expanded as the OECD becomes operational.

of aid to be granted. The DAC is to continue to function primarily as an advisory group and will not administer foreign aid. Because one of the major functions of the OECD is to improve economic and technical assistance to developing areas, the role of the DAC may become important.

*Other aid.* In addition to the Colombo Plan and the Development Assistance Committee, other regional arrangements are expected to share in the coordination and extension of aid. The European Economic Community has instituted an overseas Development Fund for use in the acceleration of growth in low-income areas. A significant amount of aid, primarily technical assistance, has been channeled through United Nations agencies, especially the Food and Agricultural Organization, the World Health Organization and the United Nations Educational, Scientific and Cultural Organization. Unilateral aid extended by advanced countries in Europe has been directed primarily toward their own respective territories and colonies. This has been especially true of Great Britain, France and the Netherlands.

### Summary

The United States government programs of unilateral transfers are principally devices through which this country achieves foreign policy objectives. The cost of the aid programs is great, but the benefits are even greater. Foreign aid has played a role in reinforcing the efforts of Allied nations in war and defense operations. It has been an important factor in the rehabilitation of war-ravaged nations and has provided underdeveloped regions with imports and technical assistance. The aid programs also serve to stimulate a greater flow of private investment by helping create basic industries and by promoting economic and political stability.

Other nations have become better trading partners as a result of assistance. With higher incomes, they provide a better market for United States goods and services and they are able to export items which either cannot be produced in this country or can only be produced at high cost. The defense posture of the United States and the rest of the free world has been improved by the mutual sharing of the necessary armament costs.

Government unilateral transfers are not the only means of promoting economic development, of cementing international relations. Private foreign investment has long been an important force in the international exchange of capital and technology and is now playing an increasingly important role in world relationships. The following chapter describes the nature and functions of private foreign investments and indicates some of its modern functions.

## QUESTIONS AND PROBLEMS

1. "During World War I the United States extended a substantial amount of credit to Allied nations so that they could obtain equipment and supplies. These countries might have expressed their gratitude for American assistance by making a greater effort to repay the loans." Comment on this statement
2. Describe the factors which motivated the World War II Lend-Lease Program. What might have been the impact on international economic transactions in the post-war period if all Lend-Lease had been on a loan basis?
3. Would the situation in Western Europe have been much different today in the absence of the European Recovery Program? In what ways?
4. "United States government loans and unilateral transfers have become a substitute for, and hence discourage, private capital movements." Comment on this statement
5. What are the advantages of coordinating foreign assistance on a regional basis, such as the Colombo Plan, as opposed to strictly unilateral assistance?
6. Discuss the objectives and nature of the Mutual Security Program
7. Discuss the major factors which have motivated United States assistance to underdeveloped countries
8. Why has the form of assistance extended to the underdeveloped countries differed significantly from Marshall Plan assistance?
9. In what ways would the United States gain if economic development were to be accelerated in low-income countries?
10. Should United States assistance to low-income countries take the form of grants or loans? Why?

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*Staff Papers Presented to the Commission on Foreign Economic Policy.* Washington, D. C.: United States Government Printing Office, February 1954. Chapter 2 of this study includes a brief description of United States foreign aid from the end of World War II through mid-1953. Certain aspects of foreign aid and technical assistance are examined, and recommendations are offered for the improvement of the programs.

The President's Task Force on Foreign Economic Assistance. *An Act for International Development: A Summary Presentation*. Washington, D. C.: United States Government Printing Office, June 1961. This study analyzes a type of foreign aid program needed to meet some of the problems of the 1960's. It examines the requirements of the underdeveloped countries and the means by which such requirements can be satisfied.

## International Investment: Nature and Characteristics

"As it seems to me, there are three ways in which one can make profit from money, besides this that he uses it for its natural purpose: One is by the banking profession, the guarding of, or trading with, money, another is usury, a third is the debasement of money. The first is base, the second evil, the third worse. . . . But as to usury, it is certain that it is evil, detestable and unjust, and proofs thereof are contained in sacred scriptures. . . ."<sup>1</sup>

These lines were written about 1370 by an eminent Church Father, Nicole Oresme. Usury, according to Oresme and other medieval Church Fathers, consisted in the taking of any interest at all and it was condemned by the canon law.

Today interest occupies an honored place in the economic lives of capitalistic nations. The lending and investment of money at interest not only takes place within the confines of a domestic economy but capital flows in the international economy, and free capital seeks investment wherever its owners find it advantageous to place it.

The abrogation of the laws against interest-taking has been of prime importance for the development of capitalistic societies. Interest-earning capital has not only meant accelerated domestic economic development, but has served to extend world economic relations. Among many other things, foreign investment has played an important role in the economic development of the United States. In the early days of the

<sup>1</sup> Oresme, Nicole *Tractatus de Origine, Natura, Jure et Mutationibus Monetarium*. Chapter XVII. Translated from the medieval Latin text in the edition of Wolowski, M. L., *Traité sur la Première Invention des Monnoies*, par Nicole Oresme, Paris, 1864.

Republic, money from foreign lands, frequently the result of state and local government borrowing, served to build American highways and canals. Following the Civil War, railroad development was financed substantially with capital obtained on the money markets of London, Paris, Amsterdam and Berlin. Many of the sugar and cotton plantations in the South were aided by foreign money as was also the development of some petroleum and mineral resources.

Although there was always some United States investment overseas—by 1897 it amounted to about \$685 million—it was not until 1900 that capital started to flow abroad from the United States in volume. It went principally to Canada, Mexico and Cuba for the development of agricultural and industrial enterprises. By 1914 United States investments abroad had reached a total of about \$2.33 billion. On the other hand, foreign investments in the United States amounted to approximately \$6 billion in that year. The United States was in that year a net debtor nation, on the capital accounts, to the extent of \$3 67 billion.

World War I rapidly changed this situation. At the outbreak of hostilities foreigners sold large blocks of their holdings of American securities, in all about \$2 billion worth, to acquire foreign exchange needed for war-time imports. During the course of the war, foreign governments borrowed extensively in the United States. When hostilities came to an end the United States was a net creditor to the extent of over \$10 billion, three-fourths of which was represented by the obligations of the Allied governments to the government of the United States. In 1914 the United States changed from a debtor nation to a creditor nation, as far as international borrowing was concerned, because beginning in that year its investments abroad were greater than foreign investments here.<sup>2</sup> International investment has also played an important role in the development of many other nations, both developed and underdeveloped, and has constituted an important outlet for the capital of the more highly industrialized nations of the world.

### Classification of International Capital Movements

*United States and foreign capital.* On the balance of payments a distinction is made between United States and foreign capital. United States capital refers to investments abroad which are owned by residents, and foreign capital means investments made by residents of foreign countries. The algebraic difference between the debits and credits for both types of capital movements indicates the net debtor or

<sup>2</sup> Taken from Lewis, Cleona, *America's Stake in International Investments* The Brookings Institution, Washington, D C. 1938.

creditor position from the point of view of capital or, as it is sometimes called, the net investment position of a country.<sup>3</sup>

*Government and private capital.* A second distinction among the capital accounts is that between government and private investment. This classification is only applied to United States capital. This is because foreign governments are not heavy investors in the United States, while the United States government makes large investments overseas. A government investment is defined by the Department of Commerce as an investment made by the government or an investment to which it is a party.

*Direct and other capital.* A third distinction is between direct and other types of investments. A direct investment is one in which the owner has a managerial interest. The Department of Commerce defines a managerial interest as one where the investors own 25 per cent or more of the voting stock of the business or in which they have a substantial voice in management. Other long-term investments consist of property interests of various types, the most important of which, stocks, bonds and notes, is frequently called portfolio investment. The distinction is one of some importance because direct investment frequently represents the migration of American business abroad. Portfolio investment does not usually represent such migration and is ordinarily made to earn interest or dividends, to find a safe haven abroad, to constitute working balances or for speculative purposes.

*Other types of capital.* Another important distinction is that made between long- and short-term capital. *Long-term capital* is defined by the Department of Commerce as an investment having a maturity of more than one year, or no maturity at all as in the case of stocks and other equity investments. *Short-term capital* is that which has a maturity of one year or less. *New issues* refer to freshly-made flotations of stocks and bonds, a part or all of which are sold abroad. *Redemptions* refer to stocks and bonds which have been repurchased, repaid or refunded by the issuing company. *Repayments* apply to the reimbursement of United States government loans which have been made to foreign governments or other institutions overseas.

Transactions in *United States government long-term securities* are shown separately since foreign government banks and financial institutions are substantial investors in these securities and maintain a part

<sup>3</sup> Two meanings are attached to the expression "debtor or creditor nation." The expression sometimes refers to the surplus or deficit on the current account where a country with a surplus is termed a creditor, and one with a deficit, a debtor nation. In other cases it refers to the net investment position, a country with an excess of investments abroad is called a creditor, and one where foreign investments in it exceed its investments abroad, is termed a debtor nation.

of their banking and international reserves in them. *Short-term liabilities to foreign banks and institutions* indicate the dollar holdings of foreign banks, deposits in the United States and sums owed to these banks by American residents. *Foreign currency holdings* by the American government include foreign currency acquired largely as a result of the sale of agricultural commodities under Section 402 of the Mutual Security Act or Public Law 480. Gold is treated as a capital account and, because of its importance in banking and international reserves, is shown separately.

### The Role of International Capital Movements

*Older views of the role of capital.* Under the Mercantilists, gold and silver were held to be the international balancing items on a nation's balance of trade. If a country ran a surplus on its current account, they believed that it received gold and silver from those nations which had a deficit with it. Conversely, if its current account showed a deficit, they held that it shipped gold and silver to those countries with a surplus. Later authors maintained that surpluses and deficits on these accounts were also financed by international capital flows. Nations with current account surpluses were held to be creditors, investing capital in countries which were experiencing deficits and those with deficits borrowed from nations which had surpluses. From this point of view, foreign capital movements, in addition to international specie flows, were balancing items and the term creditor or debtor nation referred interchangeably to a country's situation on its current accounts and to its lender or borrower position on the capital accounts.

*Capital as a balancing item.* Today, although nations with a chronic deficit on their current account are not likely to be lenders and those with chronic surpluses are not likely to be borrowers, it is generally recognized that capital movements are much more than mere balancing items. Substantial parts have an independent life and flow in and out of a nation in response to the judgments and decisions of international lenders and borrowers. Some short-term capital movements do result from balance of payments deficits and surpluses. A nation which has a deficit on its current, unilateral transfer and independent capital accounts, will see its holdings of short-term capital and its international and banking reserves decline. And those with surpluses on these accounts will have increases in these holdings.

From this point of view, capital movements can be divided into two parts—*independent and dependent capital movements*. On the balance of payments of the United States, shown on Table 31, the memorandum items numbers 1, 2 and 3 represent dependent capital move-

ments. The amount of capital used as a balancing item (dependent capital movements) can be estimated from the balance of payments, and several methods of making this computation are explained in chapter 5.

*Income on investment as a balancing item.* Sir Arthur Salter has pointed out that the deficits on Britain's merchandise accounts, 1880-1913, were financed largely by the receipt of interest and dividends from its investments abroad. These receipts were sufficiently large to enable Britain to expand its investments overseas during the period, from £1.3 to £4.0 billion, in addition to meeting the merchandise account deficits.<sup>4</sup>

The earnings of foreign investments can be of assistance in meeting deficits on the other accounts and this is an important aspect of the indirect balancing role of foreign investments. As United States investments overseas grow, earnings from them should have a larger and larger equilibrating effect on its total foreign economic relations.

*The equalization of interest and profits.* Sir Arthur also states that at certain periods the earnings on Britain's overseas investments were considerably larger than those on domestic investments.<sup>5</sup> Britain's experience with foreign investment thus points toward another role of foreign investment: Where capital movements between nations are free, they work toward the equalization of interest and profits throughout the world. Capital tends to flow from capital-surplus into capital-deficit countries in response to the spur of lower returns in the former, and higher in the latter.

Interest rates and profits are not equal throughout the world, and there are wide differentials among the rates which prevail in the several nations. But, it must be noted, capital movements are not entirely free and there are other factors which affect investment decisions besides the rate of return. Yet without the equalizing effect of international capital movements, the differences would probably be greater than they are now and, as the freedom of international investment grows, earnings differentials may be expected to become narrower.

*Capital movements and economic development.* Capital movements (especially direct investment) play an important role in the development of underdeveloped areas. Developmental projects require some domestic funds, to provide installations which can be had at home, and some foreign, for equipment and supplies which can best or only be obtained by import. If domestic savings and capital formation are

<sup>4</sup> Salter, Sir Arthur, "Foreign Investment," *Essays in International Finance* No. 12, February, 1951. International Finance Section, Princeton University, pp. 1-10

<sup>5</sup> *Ibid.*, p. 5.

sufficiently large to meet the local outlays for a project, then no foreign capital will be required on this account. The foreign funds essential to pay for the import of capital goods may sometimes be obtained by utilizing the foreign exchange earned from balance of payments surpluses, provided these surpluses are sufficient to meet the requirements. If they are not, capital must be obtained from overseas interests. In most cases, newly emerging and developing nations require substantial amounts from the more developed countries and this is one of capital's most important functions in a developing world.

### Attitudes Toward International Investment

*Hostility toward foreign investment.* There is an old English saw, "once bitten, twice shy." Many underdeveloped areas were at one time the colonial possessions of some of the great powers. Their experience has led them to believe that these powers only invest in colonies, or in the less developed areas, to exploit them, to seize their mineral resources, to buy up their land, to take advantage of their low-paid labor, to use them as mere sources of supply and market outlets for the production of the metropolitan industry.

This attitude has been translated into the hostility of several underdeveloped areas to the inflow of foreign capital, and some new nations have passed laws hampering its flow into their lands. These restrictions take many forms such as regulations governing the ownership of land by foreigners, rules restricting the exploitation of mines by others than nationals, requirements that the ownership of domestically-located enterprises be vested, partially or largely, in nationals, laws which demand the employment of a certain percentage of inhabitants in management or the labor force; restrictions on the amount of profits, interest and capital of foreign enterprises which may be repatriated in a given period, high fringe benefits, job tenure rights accorded labor together with worrisome labor laws, excessive government control over the organization and operation of the enterprise; onerous taxation, discrimination against foreign-owned firms in favor of those owned by nationals, competition from government-owned businesses. When restrictions of this nature are coupled with local political instability, the threat of war or revolution, communistic leanings, the fear of expropriation or of increasing harassment by the government, the "climate for investment" is obviously<sup>1</sup> unfavorable.

The United States government has been quite concerned about this situation and has taken a number of steps to improve it. These measures have included the negotiation of investment treaties, the inclusion of clauses in treaties of friendship, commerce and navigation

(F.C.N. treaties) to protect foreign capital, investment promotion programs; the encouragement of underdeveloped countries to take steps designed to attract funds from abroad; tax credits and tax treaties for the elimination of international double income taxation and by tax concessions granted Western Hemisphere Trade Corporations.

*Investment treaties and clauses.* Investment treaties and investment clauses in F.C.N. treaties are designed to improve the climate for investment by guaranteeing American enterprises "national treatment," among other things. These treaties and clauses provide that American-owned property and enterprises located abroad will receive the same treatment that nationally-owned property and enterprise receives. They also contain provisions designed to secure remuneration in the case of expropriation or nationalization, arrangements for the repatriation of earnings and capital and stipulations designed to provide fair tax treatment of American enterprises. A number of treaties have been negotiated and they have helped to improve the climate for American direct investment abroad.

*Investment guarantees* The investment guarantee program was first incorporated in the Economic Cooperation Act of 1948. Under these guarantees, a new investment may be protected against the risks of currency inconvertibility, expropriation and war, upon payment of a premium to the agency charged with the administration of this program. In the event that an American firm finds it necessary to invoke its guarantee, the United States government pays the claim and the guaranteed company transfers to it all claims against the foreign government. The United States negotiates agreements with foreign countries designed to establish the willingness of the country in question to participate in the program and to provide for the treatment to be accorded foreign currency, property and claims acquired when guarantees are invoked.

In spite of the apparent attractiveness of these guarantees, disappointingly few American direct investors abroad have made use of them. For one thing, the United States has not been able to negotiate investment guarantee agreements with as many countries as it would have liked. Many American businessmen do not approve of the principles involved in these guarantees and feel that they are unnecessary. They believe that the country which receives the benefits of American investment should accord the investor fair treatment as a matter of equity. They view guarantees as the wrong approach to the problem and maintain that the government should insist upon equitable treatment to its property abroad.

*Investment promotion programs.* For a number of years, the De-

partment of Commerce has had an investment promotion program designed to interest American business in investing overseas. The program has a number of facets. The Department publishes investment opportunities abroad. Its Trade Missions to foreign countries endeavor to locate investment opportunities abroad and to publicize the opportunities. Efforts are also made to interest American businessmen in investing overseas by the publication of investment manuals or handbooks of information.

Partially as a result of diplomatic prodding on the part of the United States and partially on their own initiative, many foreign nations have changed their attitudes and have instituted investment programs designed to eliminate restrictions and provide positive encouragement to foreign investment. These investment-attracting laws and practices vary widely from country to country in both scope and coverage. Most of them guarantee national treatment, eliminate discrimination and harassing restrictions and provide for the repatriation of substantial parts of earnings and capital. Others provide favorable tax treatment, free or cheap land, sites in industrial estates or other favorable locations, access to local capital, and promise government support and cooperation in the attainment of the objectives of the investors.

*Elimination of double taxation.* The threat of double taxation exists for some American investors abroad. From the point of view of the individual and corporate income tax, a distinction must be made between portfolio investments and branch offices, on the one hand, and American owned or managed corporate subsidiaries established in foreign countries, on the other. If an American invests in portfolio securities abroad, his returns from these investments are taxable just as though they were made in United States corporations and institutions. A branch of an American corporation which is not incorporated abroad may be regarded as a part of the parent company. It is thus an American resident, and its earnings may be taxable just as earnings made in the United States.

Subsidiaries or foreign corporations owned, entirely or in part, by American firms usually do not pay the United States corporate income tax *unless and until their earnings are repatriated in the United States.* Of course, both the portfolio and direct investments of Americans abroad are subject to income and other taxes levied by the country in which they are located.

Under the Internal Revenue Code, Americans are allowed a credit on their individual and corporate income taxes for income taxes paid abroad. However, in spite of the apparently liberal provisions of the Code, considerable double income taxation continues to exist. It arises

from the use of different definitions by United States and foreign taxing authorities, from the amount of foreign income taxes which the Internal Revenue Code allows as a deduction, from restrictions on the conditions under which deductions can be made and from inability in some cases to offset losses against profits.

To overcome these difficulties, the United States government has negotiated a series of treaties with various other countries for the elimination of the double taxation of income. Although these several tax treaties differ, the underlying principle of all of them is to agree upon a division of income between the two countries for tax purposes, some forms of income are reserved for taxation by the foreign country and some for the United States. The United States agrees not to tax those elements of income reserved for foreign governments and the foreign country agrees not to tax those reserved for the United States.

These tax treaties, when ratified by a two-thirds majority of the Senate, become the law of the land and take precedence over any federal, state or local tax. They have been successful in eliminating much double taxation of income between the United States and those countries with which we have such treaties.

*Western Hemisphere Trade Corporations* The United States has created the Western Hemisphere Trade Corporation to stimulate business among the nations of the Western Hemisphere. To qualify as such a corporation, the firm must be an American incorporated company, transact all of its business in the Western Hemisphere, 90 per cent of its gross income must come from the active conduct of a trade or business, 95 per cent of the gross income must be derived from sources outside of the United States and it must obtain the approval of a District Director of Internal Revenue.

Corporations which qualify are granted substantial reductions in both the normal and surtaxes levied upon corporate income as well as excess profits taxes. The computation of the tax savings varies according to the amount of income earned. As a general proposition, the total income taxes saved tends to vary from about 8 per cent in the case of a Western Hemisphere Trade Corporation earning \$25,000 or less to about 30 per cent for corporations earning over \$500,000. Due to the difficulties inherent in meeting the qualifications, relatively few American corporations have been able to enjoy these tax concessions. Nevertheless, there has been considerable agitation on the part of American firms with heavy overseas commitments to extend the Western Hemisphere Trade Corporation tax advantages to all American direct investments overseas.

Similar tax advantages were enjoyed by the China Trade Act

Corporations, established to encourage United States trade with China. Due to the restrictions on our trade with Communist China, these corporations are no longer significant factors in stimulating our trade and investment.

### Relationship Between Investment and Exports

Inasmuch as the deficits on the United States balance of payments correspond roughly to United States investments abroad, could these deficits be reduced or eliminated if the government refrained from lending money to foreign nations and discouraged private citizens from investing abroad? In other words, by reducing these balance of payments debits would the U.S. no longer face a deficit on international accounts? The answer is simply that should the United States decide to reduce balance of payments deficits, it could not completely attain this goal by restricting investments abroad. The outflow of funds supplies other nations with the currency which they use to purchase foreign goods, and without these funds exports would decline. Since exports bring an inflow of funds, if they were reduced, the deficit on the balance of payments would not disappear entirely.

*Investments as a substitute for exports.* In recent years there has been a tendency for United States investments to increase at a faster rate than exports.<sup>6</sup>

American manufacturing subsidiaries established abroad tend to replace United States exports. An American automobile assembly plant established in France, for example, will sell not only in France but export finished automobiles to the countries of Europe and perhaps to other regions. Obviously, the exports of the American parent company to the sales area of its French subsidiary will be restricted.

If an American pharmaceutical company develops a new antibiotic and licenses a West German pharmaceutical firm to manufacture it, the American firm will doubtless find its exports to the sales territory of the West German firm reduced. Neither the American automobile nor pharmaceutical parent company is likely to be greatly concerned over this turn of events, because they undoubtedly analyzed the possible results of their actions before they made the investments. The profits of the automobile assembly plant and the royalties from the West German licensing agreement presumably compensate these two parent firms for

<sup>6</sup> Exports of goods and services combined, and exports of goods alone, exclusive of military transfers, increased from 100 in 1952, the base year, to 128.5 and 121.8 respectively, in 1958. During the same period of time, total United States investment rose to 241.4, private to 245.6 and government to 230.0.

whatever profits they may lose by their inability to export to the areas covered by their direct investments.

Thus, as American firms invest directly abroad in manufacturing, assembling and distributing operations and as they license foreign firms to manufacture and distribute their products, United States exports of goods and services are restricted. On the other hand, income from investments tends to increase. Income on United States direct investments abroad doubled during the 1950's.

What has been said thus far might be interpreted as support for the view that balance of payments deficits can be reduced by eliminating United States investments abroad. If direct investments curtail exports, wouldn't it be wise to restrict them in the interest of balance of payments equilibrium?

The essence of the matter is that United States investments abroad have a dual effect on the nation's exports. In the first instance, they tend to increase exports as indicated in a previous section, but once established they tend to hold them in check. Assume that the American automobile manufacturing company invested \$500,000 in its assembly plant in France and that this subsidiary used the money to purchase machinery and equipment from its parent company. The immediate effect of this investment would be to increase exports of goods by this amount. As the assembly plant started to manufacture and sell, the exports of American-made finished autos might be curtailed.

The loss of exports due to sales made by American subsidiaries and licensees is replaced, in part at least, by income from investments abroad. This situation has been a characteristic feature of United States post-World War II balance of payments patterns. Were it not for the tendency of American subsidiaries abroad to reinvest a substantial portion of their profits in expansion and modernization programs, the growth in the receipts of income from foreign investment would have been even greater.

### Features of United States Private Long-Term Investments Abroad

*Growth of United States investments* The fact that the United States in 1914 changed from a debtor to a creditor nation, as far as its international capital position was concerned, has already been noted. At the conclusion of World War I, the United States continued to invest abroad both in foreign securities and subsidiaries. Liberty Loans of World War I days had accustomed the American public to security investment, the heavy United States credits to its Allies during the war had drawn the public attention to foreign investment, many nations were sorely in need of funds and some capital markets were closed; the

American public had large amounts of loanable funds and the rates of interest and dividends paid on some foreign investments often exceeded the returns which could be obtained from domestic American securities. As a result of these several factors, the post-World War I years were characterized by extensive investment abroad.

Although direct investments have long been an important segment of United States outflows of long-term capital, they have tended to grow in recent years at the expense of other investments. In 1945, direct investments represented about 61 per cent of all United States private long-term investments, by the end of the fifties they had increased to about 72 per cent. During the twenties and early forties, portfolio and other investments tended to increase relatively, growing from 40 per cent of the total in 1919 to 47 per cent in 1930 and from 35 per cent in 1940 to almost 39 per cent in 1945. Today, they represent a little more than one-fourth of the total of long-term investments.

*Portfolio and other investments* United States foreign portfolio and other investment experience of the twenties was not a happy one. The amounts invested were substantial. From a total of \$2.6 billion in 1919, they increased to \$7.2 billion in 1930. During the Great Depression of the thirties many foreign borrowers defaulted on the payment of both interest and principal, and American investors lost heavily. The sale of these securities on the American market became a national scandal and was one of the factors which led to the establishment of the Securities Exchange Commission. The laws which this Commission administers are designed to protect the American investor from abuses in security dealing. One government official has characterized the flotation of portfolio investments during the twenties in the following terms:

"Enticed by the prospect of commissions much higher than those available on domestic issues and faced with the necessity for a continuous flow of new securities to keep large staffs of bond salesmen employed, American investment bankers had their agents 'sitting on the doorsteps' of prospective borrowers, as one observer put it, offering them money and many times persuading them to borrow more than they actually needed. The bonds were widely distributed, in turn, to the American investing public, which was attracted by the high yields obtainable and apparently willing to rely on the judgment of the selling bankers as to the safety of the loans."<sup>7</sup>

<sup>7</sup> Lary, Hal B., and Associates, *The United States in the World Economy* United States Department of Commerce, Washington, D. C. Government Printing Office, 1943, p. 96.

The bad taste which these investments left behind combined with the decline in savings during the Great Depression of the thirties dampened interest in this type of investment, the total fell from \$7.2 billion in 1930 to \$4.0 billion in 1940. During the war years, 1940-1945, these investments increased to \$5.3 billion. In the years following World War II they continued to increase slowly until, by the end of the fifties, they totaled \$11.4 billion. Relative to direct investments, however, they have never regained the popularity which they enjoyed in the twenties.

Portfolio investments abroad consist of two broad types: Equities (or stocks) and obligations (or bonds). There are many types of foreign stocks and bonds available for foreign purchase in the principal countries of the world just as there are in the United States. Incorporation and securities laws overseas differ from those in the United States. The investor in foreign securities usually does not have the statistical, informational and analytical services to which he is accustomed in the United States.

The reasons which motivate people to invest in foreign portfolio securities are similar to those which induce them to invest in domestic securities. There is the lure of high returns. The purchase of foreign securities may also be conditioned by special factors. A firm which has established business relations with a foreign house may find it good policy to invest in the latter's securities. Financial institutions with large sums on deposit in banks abroad may invest a part of them in foreign securities to earn interest or dividends. Institutions and individuals with large domestic investments may find foreign securities a desirable means of diversifying their portfolios and spreading the risk. Investors in countries with rampant inflation or unstable governments may find domestic securities unattractive and seek safe havens in lands where there is political and monetary stability. Foreign securities may, in addition, offer the investor certain tax advantages.

*Direct investments* There are four broad categories of direct investments. (1) investments in branches overseas, (2) the creation of subsidiaries, incorporated in foreign lands, (3) licensing and cross-licensing arrangements, and (4) the establishment of international base or foreign business corporations abroad.

The *branch office* or plant of a firm overseas is not established as a separate corporate entity but is merely an extension of the home office or parent company to another land. As such, it has no separate existence. For accounting and tax purposes, the earnings and losses of the branch are a part of the earnings or losses of the parent company. These offices usually perform a particular function, e.g. sales, purchas-

ing, representational or service, and their operations are generally on a relatively small scale.

The *subsidiary* is established overseas as a separate corporation, an entity in the eyes of the law legally separate from the parent company. These subsidiaries are residents of the country in which they are established, and their earnings and losses are not those of the owning or controlling firm. Frequently they are established as new business firms, owned partially or largely by the parent firm, but sometimes American firms buy a managerial interest in existing foreign corporations which then become foreign subsidiaries. In a newly-established corporation, the parent company may own virtually all of the voting stock or it may offer some for sale to the residents of the country in which it is established.

These subsidiaries are established for a wide variety of operations which are likely to involve substantial amounts of capital. A company may set up an assembling plant abroad and ship parts and components to it for assembly into finished products. A complete manufacturing plant may be established abroad to make the products of the parent company, to use its technology, processes and patents. Wholesaling or distribution centers are created to be used as sales and distribution points to cover large geographical areas. A firm may create a parts, components and repair center to service the equipment sold by the parent firm to customers overseas.

The *licensing arrangement* is a relatively modern form of direct investment. If an American pharmaceutical company develops and patents a new antibiotic, a foreign firm may be licensed to manufacture the product against the payment of a royalty. A foreign owner of a patented new process may license an American firm to use the process under a royalty arrangement. An American firm may license a foreign manufacturer to use a valuable trademark upon the payment of appropriate sums. The owner of a copyright covering a book, play, moving picture or television script, musical composition, picture or design, may license a foreign firm to reproduce the copyrighted materials for sale provided it pays an agreed royalty.

An American and a foreign firm, each owning a number of patents in a related field, may engage in *cross-licensing*. Under such an arrangement the American firm licenses the foreign firm to use its patents, and the foreign firm licenses the American firm to use its foreign-owned patents. Licensing arrangements may involve the investment of large amounts of capital, but this is not ordinarily the case. Although direct investments arising from licensing arrangements are not large on the international capital accounts, they do have an impact on the balance of

payments because of the royalties and other payments made thereunder.

Licensing arrangements are also of some importance in the development of international cartels and present a problem for anti-trust policies. For example, if an American firm licenses a foreign firm to make its antibiotics, it is likely to restrict the selling area of the licensee. The foreign firm will not ordinarily be allowed to sell the licensed products in the United States or in a foreign market which the licensor has developed perhaps at considerable expense. Consequently, the licensing agreement may divide the sales territory between the licensor and licensee. Other restrictive business practices are often added, and some of them may raise issues under American anti-trust laws. Foreign countries generally do not have the strict anti-trust legislation of the United States nor are cartels always discouraged overseas. Accordingly, licensing arrangements often present greater problems to American business and government authorities than to foreign. American direct investors have frequently complained that anti-trust legislation constitutes a serious international competitive handicap.

**Foreign business corporations** The foreign business corporation often has the avoidance or reduction of taxes as its objective. These corporations are established abroad by American firms to carry out one or more specific operations of the parent company, which can be separated from the over-all company program, or to act as holding companies for the foreign subsidiaries of the parent company.

Assume that an American manufacturing company has an export division which handles foreign sales, distribution and servicing of the firm's products. To carry out these operations a subsidiary corporation is established. The American parent company sells its products to the subsidiary abroad which in turn exports them to the parent's foreign customers and arranges for the distribution of spare parts and servicing of the products. Better service to foreign customers and good will may be secured from such a procedure.

An American corporation may have several subsidiaries abroad and find it impossible under the United States Internal Revenue Code to offset all of the losses against the profits made by these subsidiaries. In such cases, it might pay the American parent company to organize an international base or a foreign business corporation abroad to act as a holding company for its foreign subsidiaries. By so doing it is sometimes possible to offset losses of some against profits of others before remitting net earnings to the parent company.

Since taxes are not due the United States until profits are repatriated, if the country of residence of these foreign business corporations imposes low income taxes or no tax at all, tax savings to the

American parent corporation may prove substantial. There are several thousands of these corporations established abroad by parent American firms.

### Reasons for the Establishment of Foreign Subsidiaries

After World War I, many foreign countries employed import and exchange controls to protect their scant international reserves and to conserve them for what they deemed essential imports. Under such regulations American firms experienced difficulty in exporting to many destinations, because importers in these countries could not always obtain an import or foreign exchange license authorizing the transaction. In other cases import tariffs were so high that some American products could not be sold competitively in certain foreign markets. Faced with these bars to exports, some firms established manufacturing plants abroad and made the products in the countries with the import barriers. They thus retained their foreign markets and the profits which these markets yielded.

The European Economic Community and the European Free Trade Association have proved attractive to United States direct investors. At the end of twelve to fifteen years, the countries of these organizations probably will have eliminated tariffs among the members while retaining customs duties applicable to countries outside. United States firms exporting to these nations will then have a tariff applied to their exports and be at a relative disadvantage as compared with firms located inside the areas. To overcome this impediment many United States firms are establishing subsidiary firms in the European Economic Community and Free Trade Association countries.

Some firms, such as automobile manufacturing companies where transportation is an important element of laid-down cost, discovered that a foreign assembly or manufacturing plant can save money on transportation costs and produce completed automobiles more price-competitive on foreign markets. Mining companies are obliged, of course, to establish subsidiaries abroad if the mineral deposits are found there. Sugar plantations are located in areas where the soil and climate are adapted to that type of crop. An electric power company must be located in or near the country of the users of the power. The relatively high wages prevailing in certain American industries prompt some business managers to transfer their operation overseas to take advantage of lower wage scales, a number of American firms have set up plants in Puerto Rico for this reason and other capital migrations may be expected in the future for the same reason.

If some firms are to do business at all abroad they must establish

foreign subsidiaries. A mail order house with retail store outlets decides, for example, to sell to Brazilian consumers. If it sells through its catalog, the Brazilian purchasers will have to clear each transaction through the Brazilian customs and through United States export controls. Since this is a cumbersome and expensive process the mail order house can establish retail store outlets in Brazilian cities, organize them as corporate entities under Brazilian law and customers will then no longer face import and export problems. Other firms which do not sell, but lease their products to foreign users, find a foreign assembly, manufacturing or distributing subsidiary a convenient way to handle this type of business. Other firms, making products which require extensive servicing, have found the foreign subsidiary to be an efficient means of guaranteeing adequate service to foreign customers.

In some foreign countries, where nationalism is strong, business firms from abroad are viewed with suspicion and hostility. A subsidiary established as a domestic corporation, using a local name, employing nationals in both management and the labor force and at least partially owned by inhabitants, may enjoy better public relations.

Of course, the basic reason underlying the establishment of direct investments abroad is business expansion. American firms expand abroad for much the same motives that they do in the United States. The lure of larger profits is but one reason for expansion. The desire to play the business game on a larger board and with more pieces is a powerful spur to enlarged business operations.

Such are the types, the role, the features and the motives which underlie investments abroad. Determination of the policy implications inherent in them and an examination of the amounts and results of these investments are reserved for the following chapter.

## QUESTIONS AND PROBLEMS

1. In what ways are the balances of payments effects of portfolio investment different from those of direct investment?
2. If total United States investment continues its present rate of growth, what changes are likely to appear in the future structure of our balances of payments?
3. A Communist magazine states that United States direct investments abroad are nothing more or less than a modern form of colonialism and enslavement. Comment on this statement.
4. Under what varying conditions would an American firm (a) establish a factory abroad, (b) open a branch sales office in another country; (c) erect an assembly plant overseas?

5. What effects do United States corporate and individual income taxes have on investments abroad?
6. Under what *circumstances* are American firms likely to license foreign firms (a) to use their patents, (b) to employ their trademarks?
7. To what extent may investments and income on investments be said to constitute balancing items in a country's international economic relationships?
8. Should underdeveloped nations seek investment from abroad? Why or why not? Under what conditions?
9. Define or describe Western Hemisphere Trade Corporation, investment promotion, investment guarantees, repayments, redemptions, government capital
10. Under what circumstances might an American corporation establish a foreign business corporation abroad?

For bibliography see end of chapter 14

## International Investment: Policies, Amounts and Results

"Recent years have brought an upsurge in foreign investments by U. S. industrial concerns coincident with advancing national output and incomes here and abroad . . . These investments reflect an increasing degree of integration with local economic development, resulting in many significant direct and indirect effects . . . One result of this large outflow of our private capital has been the contribution made to the programs of many countries to foster accelerated economic progress."<sup>1</sup>

The United States Department of Commerce characterized the foreign business investments of the United States in the words just quoted. These comments present an aspect of international economic relationships of growing importance to both developed and underdeveloped areas—an aspect which is one of the sources of strength of the free world. This chapter discusses some of the results of these private and government foreign investments and the operations of business subsidiaries abroad.

*Direct investments and foreign economic policy* American companies frequently carry on negotiations directly with other countries with the objective of establishing branches and subsidiaries in their territory. The agreements which they make through their own negotiations are as much a part of foreign economic policy as any arrangement negotiated officially and underline the fact that all foreign economic policy is not official, much of it is made by private business.

Once the investment plans have been made and the company is operating in a foreign country, its conduct becomes an important matter for American foreign economic relations. A largely American-

<sup>1</sup> United States Department of Commerce. *U. S. Business Investments in Foreign Countries*. Washington, D. C.: United States Government Printing Office, 1960, p. 1.

owned oil company, for example, is carrying on operations in Saudi Arabia. It pays substantial royalties to the Saudi Arabian government. It employs modern labor practices, pays relatively high wages and provides a variety of modern fringe and educational benefits for its workers. The company feels that it has a certain responsibility to the Saudi Arabians and their government, and it discharges this responsibility handsomely.

An American petroleum company in Venezuela pursues similar policies. A United States mail order house has retail store outlets in Brazil and Mexico where it provides employment opportunities at good wages. It purchases locally much of its merchandise, aiding domestic firms with capital and technology to produce these articles. The firm plows back a substantial fraction of its local earnings into expansion and improvement, pays taxes and contributes to the growth of national product and income in both countries.<sup>2</sup>

The activities of these companies and others like them are characteristic of much United States investment abroad today. The Great Depression, the reforms of the thirties, World War II and the development of the revolutionary spirit in underdeveloped areas, have all served to bring about a modern attitude on the part of business which is reflected in a growing sense of its responsibility abroad.

*Consultations with Department of State* During the twenties, American business frequently consulted the Department of State before investing directly abroad. The Department did not have the right to approve or disapprove these investments officially. If, however, its attitude were unfavorable, such investments generally were not made. Although American business still consults the Department of State and sometimes the Department of Commerce in connection with its overseas investments, today it seeks information and assistance rather than an expression of attitude. It might appear that the consultations of the twenties were desirable because they tended to bring private business programs in line with official foreign policy. On the other hand, if these consultations had expanded they might have meant an extension of government authority over business which could have important implications.

### United States Direct Investment Enterprise Operations Abroad

The operations of United States direct investment enterprises abroad have far-reaching effects on both the economies of this country

<sup>2</sup> An interesting account of the role of United States direct investments in Latin America will be found in *U S Investments in the Latin American Economy*, by Samuel Pizer and Frederick Cutler. Washington, D C. United States Government Printing Office, 1960.

and the host countries. Some of these effects can be measured quantitatively; others can only be appraised in qualitative terms. In the following sections of this chapter, the quantitative aspects of American business operations abroad are emphasized. Data measuring the scope of the work of these firms are not available in every year; the most recent year for which comparable data are available has been used in each case.<sup>3</sup>

*Production and sales.* The total sales of American direct investment enterprises overseas amounted to approximately \$32 billion in 1957, a magnitude substantially greater than United States exports of goods and services in that year and approximately 5 per cent of the domestic sales of American firms. Somewhat more than \$3.5 billion of these sales consisted of exports to the United States and accounted for more than 25 per cent of all United States imports. These companies also exported about \$5 billion worth of goods to other foreign destinations, leaving approximately \$23.5 billion for consumption in the countries in which they were located.

*Expenditures.* American direct investments not only aid in the development of the countries in which they are located by adding to their gross national products, they also contribute to the national income of the inhabitants through their expenditures which amounted to some \$37 billion in 1957. These overseas outlays represented 5 to 6 per cent of the total expenditures of all American domestic corporations of approximately \$675 billion. Wages and salaries paid in foreign countries were almost \$7 billion and were received by more than seven million employees, of which only 1 per cent were Americans. Their most important expenditure was for materials and services amounting to about \$22 billion. Relatively little was spent for imports from the United States—only about \$2.5 billion went for purchases from this country constituting about 12 per cent of all such purchases in that year.

These firms contributed to the tax receipts of the governments of the host countries. In 1957 their tax bill amounted to approximately \$4.5 billion including \$2.4 billion for income taxes and \$2.1 for indirect taxes. In some countries the income taxes paid by American subsidiaries represented over 50 per cent of all corporate income taxes collected.

*Earnings.* These investments have justified the confidence which American parent companies placed in them. In 1957 the United States

<sup>3</sup> The material in this section is based on the articles by Pizer, Samuel and Cutler, Frederick, "United States Foreign Investments: Measures of Growth and Economic Effects," "United States Assets and Investments Abroad," and "Foreign Capital Outlays and Sales of U. S. Companies," *Survey of Current Business*, Department of Commerce, Washington, D. C., United States Government Printing Office, September 1960, pp. 15-24; August 1961, pp. 20-26, and September 1961, pp. 18-24, respectively.

share of the total earnings of its direct investment enterprises overseas was more than \$3.5 billion, a return of more than 10 per cent on the book value of the invested capital. The largest earnings were made by the petroleum companies followed by manufacturing, mining and smelting. In addition to the United States share, foreign interests in these companies obtained about \$400 million, over half of which went to Canadian shareholders.

United States parent enterprises received in *declared dividends* from their overseas subsidiaries \$2.3 billion in 1960, largely from petroleum firms. These overseas establishments retained a substantial fraction of their earnings for local expansion and improvement in the countries in which they were located. In 1960 about \$1.3 billion of their earnings was invested abroad, thus adding to the total capital of the countries in which they were located.<sup>4</sup>

### International Investment Position of the United States

*Net investment position* The net investment position of the United States is computed by subtracting from the total of its investments abroad those of other countries in American firms and is shown on Table 14.1.

During and after World War II, United States investments abroad increased from \$11.4 billion in 1939 to \$71.4 billion in 1960. This contrasts with the rise in foreign assets in the United States from \$9.6 billion in 1939 to \$44.7 billion in 1960. The net investments of the United States grew by almost 1500 per cent, from \$1.8 billion in 1939 to \$26.7 billion in 1960. American government credits to foreign countries also showed considerable expansion. Starting from zero in 1939, exclusive of World War I loans, they amounted to \$21.1 billion in 1960 including loans made to Allies during World War II. Short-term capital outflows increased by 800 per cent during the period, from \$0.6 billion in 1939 to \$4.9 billion in 1960.

*Status of United States direct investment abroad.* The increase in direct investments has been an important feature of United States post-World War II international economic relationships. By 1960 they reached a total of almost \$33 billion. Manufacturing and petroleum industries accounted for the largest share with about \$11 billion each, mining and smelting, public utilities and trade followed, none showing a total of more than \$3.1 billion.

Canada, as would be expected by reason of the similarity of its

<sup>4</sup> Additional information and tables showing other aspects of the operations of American direct investments abroad are given in *U.S. Business Investments in Foreign Countries*, cited in footnote 1.

commercial laws and practices to those of the United States, its proximity and the opportunities which it offers, was the favorite location for American direct investments. These investments reached a total of \$11.2 billion in 1960. The Latin American republics, accounting for \$8.4 billion, were second with petroleum the favored industry. Heavy direct investments were also made in Europe, the Middle and Far East. Investments in Africa totaled \$925 million in 1960 and are growing.

### United States Government Loans

Government international lending and borrowing is about as old as private foreign investment. During the late Middle Ages, various rulers often borrowed from bankers in foreign countries. The American Colonies and several states have borrowed abroad. During World War I the United States government made large loans to its Allies to help them finance that conflict, and after the war its credits helped these countries carry out programs of reconstruction. Inter-governmental loans form a part of the history of almost all nations, and government international loans are an established feature of the world economy.

*Reasons for government investment.* Experience with government international investment has not always been happy for there have been a number of defaults. Because of this fact the United States has come to place more emphasis on unilateral transfers as a form of foreign assistance. In spite of the many instances of failure to respect loan contracts, governments continue to invest abroad largely because it is an important arm of foreign economic policy. The attainment of foreign objectives, made possible or implemented by foreign loans, is frequently more important than the cash value of the loan itself. War-time credits granted to Allies are a case in point. Loans have sometimes been made to attract governments away from alliances with other countries or to assure that they will remain "on our side." They have also been used to maintain peace and stability in certain areas. Some of the credits granted during World War II to neutrals were made to attain these objectives. Governments frequently grant loans to under-developed countries in order to develop their economies and help them become better markets for products.

From another point of view, government international investment takes place because private investment is not possible or does not meet all requirements. A projected loan may be too large or the risk too great for private lenders. In such cases governments may step in, if they deem the investment worthwhile, and grant the desired credits. Government international investment, from this point of view, may be regarded as complementary or supplementary to private.

*Magnitude of government investment.* Table 14.1 presents the total amount of United States government credits and claims excluding World War I loans for selected years, 1939-1960. In 1960 they stood at \$21.1 billion—almost 30 per cent of the total investment, both private and government, of \$71.4 billion.

*Government lending procedures.* The government investment program is coordinated by the National Advisory Council on International Monetary and Financial Problems (NAC) composed of the Secretaries of State, the Treasury, Commerce, the Chairman of the Board of Governors of the Federal Reserve System and the Chairman of the Board of Directors of the Export-Import Bank of Washington. All proposals and requests for government credit are examined by the NAC which determines and unifies federal investment policy.

The amount of credit extended by the United States through its major foreign assistance programs since 1945 is presented in Table 14.2. On the average, it has amounted to slightly more than \$1 billion each year. Although a large share of United States loans are either extended or administered by the Export-Import Bank of Washington, the Development Loan Fund has provided loans which are advantageous to low-income countries. Loan operations are also carried on in connection with the Agricultural Trade Development and Assistance Act.

*The Export-Import Bank of Washington.* The Export-Import Bank of Washington (Ex-Im Bank) is a government agency which was created in 1934 to extend loans for the expansion of United States foreign trade. Increased exports were desired at that time as part of government efforts to increase domestic employment and to promote economic recovery. Gradually the Ex-Im Bank was granted increases in its lending authority, and it has become an important medium through which the United States government seeks to achieve certain foreign policy objectives. A sizable share of government loans has been channeled through or administered by this agency, which over the years has become one of the more important sources of medium- and long-term federal credit and loan guarantees.

The Export-Import Bank, which in 1958 had its lending authority expanded to \$7 billion, obtains most of its financial resources by borrowing from the United States Treasury. The Bank provides funds for financing exports, for reconstruction and for development projects. Its loans, which must be economically sound and self-liquidating, may be extended to domestic or foreign firms and to foreign governments or their agencies. Financing is available from the Bank only in instances where the potential borrower is unable to obtain it through normal commercial channels. Generally, it attempts to limit its assistance to

TABLE 14.2

NEW CREDITS EXTENDED BY THE UNITED STATES  
THROUGH ITS MAJOR FOREIGN ASSISTANCE PROGRAMS<sup>1</sup>

(in millions of dollars)

Year	Amount
July 1945-	
Dec 1953	
1954	11,502
1955	387
1956	427
1957	495
1958	1,029
1959	1,147
1960	1,032
	1,041
Total	17,059

<sup>1</sup> Includes disbursements of the Export-Import Bank, through the Mutual Security Act and the Development Loan Fund, and under the Agricultural Trade Development and Assistance Act

Source: United States Department of Commerce *Statistical Abstract of the United States 1961* Washington 1961, p. 870

cover only the foreign exchange requirements involved in the construction of a given project. Another feature of the Bank's loans is that they are "tied," i.e., the proceeds must be spent on items procured from the United States. Disbursements of the institution since its inception in 1934 through June 1960 have amounted to slightly more than \$7 billion. The greatest share of these loans has been extended since the end of World War II.

The Bank has assisted in various financial operations of such government agencies as the Economic Cooperation Administration and the International Cooperation Administration. It also administers the local currency loans extended to private firms under Public Law 480. In addition it is authorized to guarantee loans which will promote United States trade with foreign nations.

Operations of the Ex-Im Bank have been subjected to both approval and condemnation. Criticism has been directed toward the Bank, because its transactions are influenced by government policies. Proponents of the Bank reply by pointing out that the United States must use all the means at its disposal to give effect to its policies and that the Ex-Im Bank loans should not be overlooked in pursuing its objectives. Another criticism relates to the fact that the Bank's loans are tied. Tied loans are criticized as undesirable because borrowers may be prevented from utilizing the proceeds in the most economic fashion and because they are not conducive to multilateral trade.

A favorable aspect of the Bank is that it is an additional source of funds through which international trade and development projects can be financed, its loans represent a net increase in the flow of international investment. The Ex-Im Bank has been financially successful, it has sustained but few losses and has returned large net profits to the Treasury.

*The Agricultural Trade Development and Assistance Act* In 1954 the United States introduced a program, the Agricultural Trade Development and Assistance Act (Public Law 480), designed to combine the disposal of domestically-produced surplus agricultural commodities with foreign economic assistance. Title I of this Act authorizes the exchange of United States surplus agricultural products for the local currencies of certain foreign countries. Titles II and III authorize the donation of surplus commodities to alleviate malnutrition, starvation and emergency disaster.<sup>3</sup> Reasonable precautions are taken to assure that Public Law 480 operations do not interfere with the usual marketings of the United States and with the trade of friendly nations. The total export value of agricultural products disposed of under the three Titles has averaged slightly more than \$1 billion a year. Since its inception, approximately one-quarter of the total value of United States agricultural exports has been channeled through this program.

Loan operations arise out of Public Law 480 operations as a result of the local currency sales under Title I. The currencies accumulated are the property of the United States government, but as shown in Table 14.3 about one-half of the total has been loaned to private firms or the government of the purchasing country for development purposes. Repayment is normally made in the type of currency originally borrowed. Almost one-fourth of the total currency proceeds has been granted to host countries for purposes of common defense and economic development. The local currencies are valuable to the host country because they can be used to cover the domestic costs of various projects. Local currencies not loaned or granted are either used by the United States government for its administrative expenses in the host country or are retained for future contingencies.

An advantage of Title I is that recipient countries receive food and fiber products on relatively favorable terms. Because purchases can be made with local currencies, these countries need not give up foreign exchange. It should be noted that agricultural products are available under this program only after a country has made its usual purchases from the United States. A second advantage is that the local currencies

<sup>3</sup> Operations under Titles II and III of Public Law 480, as well as Section 402 of the Mutual Security Act, are primarily grants.

TABLE 14.3

DISPOSITION OF PUBLIC LAW 480 LOCAL CURRENCIES AS PROVIDED BY AGREEMENTS  
SIGNED JULY 1, 1954 - JUNE 30, 1961

(in thousands of dollars)

Use	Amount	Per cent
Common defense	398,804	6.0
Grants for economic development	1,126,614	17.1
Loans to private enterprise	399,172	6.0
Loans to foreign governments	2,939,758	44.4
For United States purposes	1,752,575	26.5
Total	6,616,923	100.0

Source, *The 14th Semiannual Report on Activities of the Food-for-Peace Program Carried on under Public Law 480, 83d Congress, As Amended* House Document No. 223, 87th Congress, 1st Session Washington U.S. Government Printing Office, 1961, p. 81

amassed under Title I can be employed by the host country to provide capital for desirable projects.

A disadvantage lies in the fact that many of the recipient countries are ex-colonies, and they may resent foreign control of a share of their money supply. Operations have also created conflicts with other agricultural exporting nations which object that they are losing foreign markets to the United States. Although the surplus sales are not to interfere with *usual* marketings of other friendly nations, it appears that the United States has absorbed the greatest share of the *increase* in world markets for agricultural products. This is damaging to some of the low-income countries which rely on wheat, cotton and rice exports as important sources of foreign exchange receipts.

**Development Loan Fund** The United States government created the Development Loan Fund (DLF) in 1957 to provide assistance tailored to suit the needs of some underdeveloped regions. During its short period of operations, the DLF provided financing for economic development on flexible and favorable terms which were especially advantageous to countries with limited repayment capabilities. Loans from this agency were more generous than the usual commercial loans. First, the DLF was authorized to accept repayment in local currencies where dollar repayment would prove burdensome. Second, even if dollar repayment was expected, convenient terms were arranged; in some cases, no interest was charged and repayment could be made over a fifty-year period with provision for grace periods. In October 1959 the DLF commenced to emphasize tied loans, that is, the loan proceeds were to be employed to purchase goods and services from the United States.

The sole objective of this agency was to provide financial resources for economic development, and it allocated funds only for specific

development projects or programs. Loans could be extended either to private firms or government entities, but they complemented rather than competed with those from the World Bank, the Export-Import Bank and private institutions.

The DLF has made loan commitments for such purposes as the expansion of a sugar mill in Bolivia, a power plant in Libya, a fertilizer plant in Greece, and railway development in India. By far the largest volume of credit has been extended for transportation, communications, industrial and power facilities. Through January 1960 funds had been earmarked for more than 115 projects in 43 countries, and commitments totaled about \$950 million. In 1961 the DLF was terminated as a corporate entity, and its functions were incorporated into the newly-created Agency for International Development.

### Foreign Direct Investments in the United States

Foreigners have long maintained substantial investments in the United States, largely of the portfolio type. Their portfolio holdings amounted to over \$4 billion and direct investments to \$1.5 billion in 1929. By 1960, these portfolio investments stood at \$11.5 and direct at \$6.9 billion. Foreign investors, like their American counterparts, have recently been using the direct type in preference to the portfolio. During the period 1929-1960, portfolio investments increased by 290 per cent and direct investments by 460 per cent. Between 1950 and 1960, foreign investment in the United States increased on the average \$350 million annually.

*Nature of foreign direct investments in the United States.* There are important differences between foreign direct investments in America and those of the United States abroad. American direct investments abroad are about five times as large as those of foreigners in the United States and have increased at a faster rate. United States capital is attracted by resource development and processing facilities in foreign lands. Investment by foreign interests in American enterprises favors the financial and insurance business. But relatively few countries invest in the United States, while American companies have invested in a large number of countries.

United Kingdom residents have been consistently the largest holders of American direct investments and account for nearly one-third the total. Their holdings are largely concentrated in the insurance business. Other substantial investors in America are the Netherlands, Switzerland, Canada, France, Belgium, West Germany and Italy. In addition to insurance and financial institutions, manufacturing industries have proved attractive to foreign investors. Machinery, textiles,

beverages, paper products, chemicals and artificial fibers account for the bulk of foreign direct investments in United States manufacturing enterprises. Foreign petroleum holdings consist principally of British-Dutch firms and Canadian pipelines.

*Earnings and sales.* Although foreign investments in America amount to about one-fifth the value of those of the United States abroad, their earnings are approximately one-tenth of American overseas firms. The greater earnings of United States enterprises abroad can be explained by the differing industry composition of the investments. The earnings of foreign subsidiaries in the United States have averaged between \$300 and \$400 million a year during the past decade and are showing a tendency to rise.

About 60 per cent of the profits of foreign direct investments in America was paid out in dividends and 40 per cent was reinvested. These firms sold about \$81 billion worth of goods and services in 1959. The largest sales were those made by manufacturing companies (\$51 billion), followed by petroleum (\$2.4 billion) and \$900 million for chemicals and related products. About 75 per cent of the revenue from sales was used to pay for cost of goods sold and depreciation while approximately \$400 million was paid to United States authorities for taxes equally divided between income and other levies.<sup>6</sup>

*Significance of United States investment position.* The magnitudes presented in this chapter indicate the growing importance of foreign investment in the world's international economic relationships. They underline the fact that the United States is a creditor nation capital-wise and is contributing by funds and technology to the growth of many countries, both developed and underdeveloped. If present trends continue investment is likely to loom larger, trade in goods and services may come to occupy a relatively smaller place in the patterns of United States balances of payments.

Another form of foreign investment, that made by international lending institutions, is described in Chapter 24. The theory which underlies the trade of nations and which at least in part conditions international investment is discussed in the next chapter.

## QUESTIONS AND PROBLEMS

- 1 Both the federal government and American direct investors abroad make United States foreign economic policy. What are the advantages and disadvantages of this dual policy system?

<sup>6</sup> Additional information concerning foreign direct investments in the United States is given in Pizer, Samuel and Warner, Zale V., "Foreign Business Investments in the United States," *Survey of Current Business*, Department of Commerce, Washington, D. C. United States Government Printing Office, October 1961, pp. 11-16.

2. The Department of Commerce does not include in its balances of payments figures showing the re-investment of the earnings of direct investments abroad as a part of capital outflows. The International Monetary Fund, in its balances of payments, includes these re-invested earnings as a part of the capital outflow of the country of the parent company. Which of the two methods is preferable? Why?
3. Write a note on each of the following aspects of United States direct investments abroad: (a) earnings, (b) income gained by Americans, (c) sales of manufacturing enterprises, (d) re-investment of profits.
4. What impact have United States direct investments had upon the economies of foreign nations?
5. Why has the United States government invested abroad?
6. What are the functions of the Export-Import Bank of Washington?
7. How are the lending policies of the United States government coordinated?
8. Should the United States assist underdeveloped countries with loans or with grants? Why?
9. In what respects are United States government loans complementary and supplementary to those made by private business?
10. Compare foreign direct investments in the United States with American direct investments overseas.
11. Account for the growth of foreign investments in the United States.

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its pattern and role, conditions for a good investment climate, and the relationships between public and private overseas investment.

The National Planning Association of Washington, D. C. has published a number of monographs dealing with the organization and operations of specific American firms located abroad. These are: *Casa Grace in Peru*, *Creole Petroleum (in Venezuela)*; *Sears, Roebuck of Mexico*; *Socony Mobil in Indonesia*, *I B M in France*. These works stress the contributions which certain American firms have made to the countries in which they are located.

### Sources.

The basic sources of statistical information on United States investments abroad and foreign investments in the United States are to be found in the various censuses of its foreign investments. The earliest of these, undertaken by the Treasury Department in 1942 and 1943, provide benchmark data on the status of United States foreign investment for the periods covered. The results of the censuses were published in the *Census of Foreign-Owned Assets in the United States*, United States Treasury Department, Washington, D. C. United States Government Printing Office, 1945 and the *Census of American-Owned Assets in Foreign Countries*, United States Treasury Department, Washington, D. C.: United States Government Printing Office, 1947. The data presented are kept up to date by the Department of Commerce in its *Survey of Current Business* especially in the August and September issues of each year. In 1950, the Department of Commerce took another census of foreign investment the results of which appeared in *Foreign Investments of the United States*, A supplement to the *Survey of Current Business*, United States Department of Commerce, Washington, D. C. United States Government Printing Office, 1953. The latest census was taken by the Department of Commerce in 1960, and some of the results were published in the *Survey for September 1960* under the title of "Foreign Investments—Summary and Analysis of Recent Census. Current Trends and Economic Effects," and in the October, 1960 issue, "Capital Outlays Abroad by U. S. Companies." More complete results of this census are given in a monograph *U. S. Business Investment in Foreign Countries*, United States Department of Commerce, Washington, D. C. United States Government Printing Office, 1960. Recent information on foreign investments in the United States will be found in Pizer, Samuel and Warner, Zabe V., "Foreign Business Investments in the United States," *Survey of Current Business* October 1961, pp. 11-16. Statistical information on capital movements abroad will be found in the *Balance of Payments Yearbooks* published annually by the International Monetary Fund which contain data showing the movement of capital, both domestic and foreign, for each member country. The monthly publication of the Fund, *International Financial Statistics* also provides data on the investment position of the member countries. The *Staff Papers* published by the Fund from time to time contain articles on international investment.

## The Development of Classical Trade Theory

"What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of our own industry, employed in a way in which we have some advantage."<sup>1</sup>

Adam Smith, in the late 1700's, thus characterized the advantages of individual and international specialization. His treatise, *An Inquiry into the Nature and Causes of the Wealth of Nations*, presented a penetrating criticism of the Mercantile System. Yet it was much more than this for in it he showed the benefits of an alternative system, that of freedom in economic pursuits.<sup>2</sup>

### Absolute Advantage

Two major themes dominate the *Wealth of Nations*, that of *laissez faire* and that of specialization or the division of labor. In contrast to the Mercantilists, Smith espoused a belief that *society would benefit if government intervention in economic life were reduced to a minimum*. With the "invisible hand" concept, he advanced the thesis that *when individuals remain free to pursue their own self-interest, the greatest welfare of society is assured*. Second, Smith strongly advocated specialization and demonstrated how *the division of labor promotes higher productivity and hence maximizes economic well-being*.

*Application to international trade.* The benefits of *laissez faire* and the division of labor were also applicable to the international economy

<sup>1</sup> Smith Adam, *An Inquiry Into the Nature and Causes of the Wealth of Nations* Vol I, 1910 edition Everyman's Library, Edited by Ernest Rhys London: J. M. Dent & Sons, Ltd., p. 401

<sup>2</sup> Smith was not the first writer to expose some of the fallacies of the Mercantilist literature. Earlier critics included the Physiocrats (see chapter 2) and David Hume, who advanced the price-specie-flow mechanism (see chapter 9).

Smith asserted that an individual would not ordinarily attempt to produce at home those goods which would cost him more to make than to buy. He argued that if specialization and exchange is beneficial for individuals it must also be beneficial for nations. Free trade promotes the division of labor and is a prerequisite for the most advantageous employment of a country's industry.

Smith's explanation of the reasons for trade was cast in terms of absolute advantage; a country would export (import) a commodity if it produced the commodity at a lower (higher) cost than other nations. If specialization is to occur, international trade in goods and services must take place. Because of the nature of trade, countries must be willing to import as well as to export if they are to achieve the potential benefits which it offers. Government interference in the form of trade barriers tends to preclude an international division of labor and the concomitant benefits of greater production. However, Smith recognized that protection of domestic industries might be justified under certain circumstances, such as for defense purposes.

*Impact of Smith's writings.* The *Wealth of Nations* had a powerful impact on the economic thought of its day and marked the beginning of the Classical School, which was to dominate economic philosophy for the next century. The immediate and widespread popularity of his book in part reflects the fact that it was consistent with the conditions of the time. Although Smith provided a strong case for unrestricted trade and exchange, a more far-reaching theoretical framework was advanced by David Ricardo.

### The Principle of Comparative Costs

The fundamental argument for international specialization and exchange of goods and services rests on a theory popularized by David Ricardo (1772-1823).<sup>3</sup> His analysis, now called the principle of comparative costs, marked an advance over Smith's for Ricardo reasoned that it might be advantageous for a nation to import an item even if it could be produced internally at a lower cost. Much of today's international economic theory represents either a modification or a refinement of this early principle.

Ricardo's model was simple and phrased in real terms, labor and units of commodities, rather than in terms of prices and costs.<sup>4</sup> He

<sup>3</sup> Ricardo, David *Principles of Political Economy and Taxation* Edited by E. C. K. Gonner London: George Bell and Sons, 1891, pp. 108-130.

<sup>4</sup> Jacob Viner has suggested that Classical writers employed real costs not as a substitute for money costs, but to give greater significance to welfare analysis. See Viner, Jacob *Studies in the Theory of International Trade* London: George Allen & Unwin, Ltd., reprinted 1955, pp. 483-484.

assumed: (a) two countries, Portugal and England; (b) two commodities, wine and cloth; (c) one unit of wine exchanges for one unit of cloth in international trade; and (d) the costs of producing the two commodities were denominated in terms of units of labor time. The labor time required to produce wine and cloth in Portugal and England was as follows:

	Portugal	England
Wine (1 unit)	80 men a year	120 men a year
Cloth (1 unit)	90 men a year	100 men a year

*Benefits for Portugal.* In this example, Portugal requires fewer units of labor to produce both wine and cloth than England, accordingly the cost of producing these items is less in Portugal than in England. Yet it would be advantageous for Portugal to concentrate on the production of wine for domestic use and for exportation and to import cloth from England. If Portugal specializes in wine production, a unit of wine, which requires the labor of 80 men, will purchase one unit of cloth from England. But if Portugal diversifies and produces both wine and cloth, one unit of cloth requires the labor of 90 men. Thus Portugal would achieve a saving of the labor of 10 men with the production of every unit of wine, which can be traded with England for one unit of cloth.

Accordingly, it would be to Portugal's advantage to devote her productive facilities to wine which would exchange for more imported cloth than could be produced at home with the same amount of labor.

*Benefits for England* Portugal, which can produce both wine and cloth at lower labor costs, and England where labor costs are higher for both items, would both benefit by specialization and international commerce. If England concentrates on cloth production, a unit of cloth, which requires the labor of 100 men for one year, will be sufficient to obtain one unit of wine from Portugal. But the production of one unit of wine will require 120 men if England produces both wine and cloth. Accordingly, England will save the labor of 20 men for a year if she specializes in cloth production and engages in international trade to obtain the wine. Hence if England specializes in cloth production, it also uses labor more efficiently and would benefit along with Portugal.

*The principle of comparative costs.* The absolute costs of production are not relevant in determining what commodities a country can export or import most advantageously. A country should employ its resources in the most profitable alternative, either in the production of items for which it has the greatest comparative advantage or of those for which it has the least comparative disadvantage. Portugal has an

absolute advantage in the production of both wine and cloth, but the greatest comparative advantage in the production of wine. England, not having an absolute advantage in either commodity, would benefit by producing cloth in which she has the least comparative disadvantage. Portugal would benefit by the importation of cloth despite the fact that its labor costs for this item were lower than in England. The major contribution of Ricardo's comparative cost doctrine was the demonstration that with free trade a commodity need not be produced in the country where its cost of production is lowest.

*Premises of the Ricardian model* One of the assumptions of Ricardo's model was that the exchange value or price of commodities in each country is proportional to the labor time embodied in them. If it takes a worker one day to produce a commodity and two days to produce a second, the price of the second would be twice that of the first. In Portugal one unit of wine exchanged for 8/9th unit of cloth; in England, for 1.2 units of cloth. As long as the relative costs differ, a basis for trade exists. Ricardo, in addition, asserted that the factors which regulate the relative values of commodities within a country do not regulate their relative values in international trade. The amount of a commodity exported to obtain imports is not determined by the quantities of labor embodied in each product as it is in domestic trade. In his example, Ricardo assumed that a unit of wine exchanged for a unit of cloth as trade is initiated between these two countries. Labor time was not a determinant of prices in international exchange.

This position is not inconsistent when the premises of the Classical thought are considered. The premises of this school were the labor theory of value, free competition and internal factor mobility. The Classical authors also assumed that the domestic exchange ratios of different goods and services were proportional to the ratios of labor time embodied in each commodity. They also held that productive resources are immobile between countries. It follows from these postulates that values in international trade, as expressed in terms of exchange ratios or prices, are not established in the same manner as domestic values. Domestic exchange values were assumed to be determined by the labor content of commodities. In international trade it was assumed that goods would not exchange at their labor values because labor was considered to be immobile between countries. Only if productive resources moved freely between nations would prices in international trade be determined in the same manner as in domestic trade.

*Problems arising from the Ricardian model* Because of the simplicity of the Ricardian model, it was subjected to attack and modification at the hands of subsequent writers. One problem arising from

Ricardo's analysis was the use of labor time as a common denominator of costs and as the determinant of comparative advantage. However, Ricardo did not abstract money costs. He explained that a commodity would not be exported unless it sold for more gold in a foreign country than what it would cost to produce domestically. He recognized that trade was governed by money prices and costs, but he assumed labor costs were proportion 1 to labor time; accordingly it made no difference which was used. This assumption was criticized by John Cairnes and was later modified by F. W. Taussig who substituted labor costs for labor time.

Current value theory integrates the roles of supply and of demand in price determination. But Ricardo, along with several other early writers, failed to develop the nature of demand and attributed value to the cost of production or to supply conditions. Ricardo used the amount of labor time required to produce a commodity to measure the value of that commodity. Although capital is employed in production, he assumed that it could be considered accumulated or indirect labor. Thus, according to Ricardo, value is measured by labor time. Most later exponents of the comparative cost doctrine, including John Stuart Mill, rejected this theory of value, but many of them employed the terminology of costs of production for the sake of simplicity in their analysis of international commerce.

Another problem arising from Ricardo's analysis related to the terms of trade or the exchange ratio of commodities between countries. Ricardo supposed that a unit of wine exchanged for a unit of cloth and made no attempt to explain how values were determined in international trade. It remained for John Stuart Mill and John E. Cairnes to explore the nature of internal and external values more carefully.

Ricardo also assumed that labor and capital moved freely within a nation but were immobile between nations. His conclusion that domestic trade was distinct from international trade was derived from this premise. Cairnes later challenged the assumption of factor mobility within a region, considerably later Eli Heckscher and Bertil Ohlin both questioned the assumption of factor immobility between nations.

Another premise of Ricardo's analysis was that costs of production remain constant regardless of the level of output. This supposition leads to the conclusion that a country would either produce or else import all of any given commodity and would not import a part and produce domestically the remainder for its own needs. Conditions of increasing costs exist for some commodities, however, which means that as a nation's output of these products increases, unit costs also increase. Comparative cost ratios are altered by changes in unit costs.

which affect both the volume and composition of trade. Finally, a situation of decreasing costs might prevail for some products which would also affect the flow of trade. Subsequent writers, including Gottfried Haberler and Bertil Ohlin, incorporated conditions of increasing and decreasing costs into their analysis.

A final shortcoming of Ricardo's analysis was that it failed to explain adequately the reasons for differences in costs of production in various regions. Most early writers simply attributed such differences to climatic conditions. Ohlin concluded at a much later date that cost differences resulted from the relative variations in factor endowments of various trading regions.

### Terms of Trade

Ricardo's analysis of international trade was further developed by John Stuart Mill (1806-1873) in the middle of the nineteenth century. Mill directed his attention to the volume of exports exchanged for imports or the *terms of trade* which are established as goods and services flow between nations.<sup>3</sup> Ricardo's treatment of this topic had been superficial.

*Nature of Mill's model.* Mill assumed that, in the absence of international trade, domestic costs of production generally determine exchange values or prices of commodities. Like Ricardo, he also started with a two-country, two-product model. From his example.

In England's domestic trade 10 yards of broadcloth exchange for 15 yards of linen,

In Germany's domestic trade 10 yards of broadcloth exchange for 20 yards of linen.

If England were to specialize in broadcloth and Germany in linen production, both countries would benefit through international trade. But if England could get only 15 yards of linen for 10 yards of broadcloth, there would be no gain by foreign trade because the same trade ratio prevails in the domestic market. England will benefit only if it can obtain more than 15 yards of linen for 10 yards of broadcloth. If Germany gets 10 yards of broadcloth for 20 yards of linen, it also would not profit by foreign trade. To benefit, Germany must give less than 20 yards of linen to get 10 yards of broadcloth.

On the basis of these factors, Mill concluded that the outer limits within which commodities can be profitably exchanged in international trade are set by the rates at which commodities exchange in the domestic trade of each of the countries. In England, 10 yards of broadcloth

<sup>3</sup> Mill, John Stuart *Principles of Political Economy* Edited by W. J. Ashley. London: Longmans, Green and Co., 1920, pp. 574-606.

are given for 15 yards of linen or 10:15; in Germany, 10 yards of broadcloth exchange for 20 yards of linen or 10:20. In the trade between the two countries the exchange ratio must be within the range of 10 yards of broadcloth for between 15 and 20 yards of linen, or between 10:15 and 10:20. Only within this range will both countries benefit, thus providing the necessary incentive for international trade.

*Supply, demand and the terms of trade.* Domestic costs do not determine exactly the ratio at which commodities exchange in international trade. Although domestic cost ratios set the outer limits within which trade occurs, Mill stated that the *equilibrium terms of trade are dependent upon supply and demand, or the relative strength of demand between two countries for each other's products*. In other words, the terms of trade depend upon what is now termed *reciprocal demand* or the amounts of domestically-produced articles which each country is willing to relinquish to obtain units of foreign-produced items. Furthermore, the stronger a country's demand for a second country's exports, the more unfavorable its terms of trade. Accordingly, from Mill's example:

(a) If England's demand for linen imports is relatively intense, the ratio might be set at 10:16. In this case, Germany would gain most from trade or the terms of trade would be in its favor.

(b) If Germany's demand for broadcloth imports is relatively intense, the ratio might be set at 10:19. England would gain most from the trade and the terms would be in its favor.

*Domestic cost ratios determine the range, and the relative strength of reciprocal demand sets the actual terms of trade within this range.* When the terms of trade are in equilibrium, the value of each country's exports just equals the value of its imports, a condition which Mill referred to as the "Equation of International Demand." The value of the amount exported is equivalent to that of imports to consumers. Suppose that at the equilibrium international price, the ratio of exchange is 10:18. This would mean that for every 10 yards of broadcloth imported by Germany, 18 yards of linen would be exported. Alternatively, the value of 10 yards of broadcloth would be equal to the value of 18 yards of linen.

*Gain from trade.* Trade between countries fosters specialization which induces a higher level of world output. If all countries are to benefit from trade, the increased output must be shared in some manner. According to Mill, *the gain from trade for each country is represented by the difference between the equilibrium external price and the domestic cost ratio*. Again assuming a 10:18 external price ratio, England, with a 10:15 domestic cost ratio, would get 18 yards of linen for 10 yards of broadcloth. There would be a net gain of 3 yards of

linen for every 10 yards of broadcloth exported. Germany, with a 10:20 domestic cost ratio, would obtain 10 yards of broadcloth for only 15 yards of linen and would save 2 yards of linen for every 18 exported.

If the ratio of exchange with foreign trade is 10 yards of broadcloth for 16 yards of linen, Germany obtains most of the advantage in trade; if the ratio is 10:19, England gains most. Only if the ratio is at one of the extremes, 10:15 or 10:20, does just one of the countries benefit; within this range, both countries share in the gains from trade.

*Other aspects of Mill's analysis.* Mill broadened his analysis by briefly investigating cases involving more than two commodities and more than two countries. He concluded that regardless of the number of countries and commodities, the same essential principles apply as in trade between two countries and with two commodities. He also reasoned that transportation costs alter the prices of internationally-traded goods, but found that it is impossible to specify how this cost is divided among the trading nations.

The major significance of Mill's analysis was that it demonstrated how exchange values are established in international trade and showed what the gains are to each country. He thus partially closed a gap in Ricardo's presentation. Both Ricardo and Mill regarded labor costs of production or supply factors as the determinant of exchange values or prices in domestic trade. The labor theory of value, they assumed, could not apply to values in international trade because factors of production were assumed to lack mobility between nations. While Ricardo virtually ignored the conditions influencing external prices, Mill used both demand and supply in the determination of prices in international commerce. Mill did not integrate domestic and external value theories because domestic prices, in his analysis, are determined by supply or cost factors and prices in international trade, by both demand and supply. Because of the underlying assumption that the factors of production were relatively immobile between nations, international trade theory was distinct from theories relative to domestic production and exchange.

### Modification of the Principle of Comparative Advantage

The basic case for unrestricted world trade was proposed by Smith, Ricardo and Mill. But the premises of the comparative advantage doctrine which they set forth were not completely realistic. Because they were in conflict with certain conditions in the actual world, the principle did not receive wide acceptance. The assumptions relating to the labor theory of value and the mobility of the factors of production were especially weak. As a consequence of the efforts of subsequent writers who attempted in some cases to salvage, in others to

invalidate, the principle of comparative advantage, the body of trade theory has been refined and modified. Among those who contributed to a restatement of the principle of comparative advantage are Nassau W. Senior, John E. Cairnes, Alfred Marshall and F. W. Taussig.

**Nassau W. Senior** In the analysis presented by Ricardo, domestic costs of commodities were assumed to be determined by the labor time embodied in the product. Nassau W. Senior (1790-1864), a contemporary of John Stuart Mill, asserted that the prices of commodities are not necessarily proportional to the quantities of labor embodied in them. According to Senior, the reciprocal values of commodities or the quantity of one commodity exchanged for a second need not always correspond to costs of production. Instead, reciprocal values depend upon conditions which give an article usefulness or utility and factors which limit the availability of the article. Furthermore, costs of production include not only the real cost of labor in terms of disutility of labor but also the real cost of capital in terms of the disutility of the abstinence from consumption involved in saving.<sup>6</sup>

Senior was also concerned with the determination of the relative level of money incomes in various trading countries. He argued that wage levels in export industries depend upon their productivity. Hence relative wage levels in the external sectors of different countries are proportional to the labor productivity of their export industries. Furthermore, wages earned in the export industries determine and, at equilibrium, with allowances for the disagreeableness of certain tasks, equal the level of wages throughout the domestic economy. Accordingly, productivity in the external sector determines the relative levels of wages of different economies. Senior concluded that high wages rates are not necessarily an obstacle to international trade because money wages reflect the productivity of labor.<sup>7</sup> Senior may have overemphasized the role of export industries, but he recognized that wages in an economy are not independent of factors in other economies.

**John E. Cairnes.** The development of the principle of comparative advantage was furthered by John E. Cairnes (1832-1875).<sup>8</sup> One of the problems to which he directed his attention was the theory of value in domestic and international trade.

Both Ricardo and Mill had reasoned that domestic prices were

<sup>6</sup> Senior, Nassau *An Outline of the Science of Political Economy* London George Unwin Ltd., Sixth edition, 1836 (Published in the Library of Economics, 1938, pp 13-60 )

<sup>7</sup> Senior, Nassau W. *Three Lectures on the Cost of Obtaining Money* London John Murray, 1830, pp 1-35

<sup>8</sup> Cairnes, John E. *Some Leading Principles of Political Economy Newly Expounded* New York, 1874

determined by supply factors or costs of production. If one can assume long-run equilibrium and perfect competition, prices will tend to equal the costs of production. Cairnes maintained that competition is not the usual situation and that perfect mobility of the factors of production does not exist. Because labor does lack mobility, *non-competing labor groups* exist which prevent *labor time* from being proportionate to *labor costs*. Labor is not homogeneous, and it fails to shift from industry to industry and occupation to occupation to equalize wage rates. Due to its immobility, a commodity which takes a worker one day to produce need not necessarily have the same market price as another which is produced in one day by a different worker. According to Cairnes, the volume and direction of trade are influenced by wage rates and costs of production rather than by labor time.

Cairnes asserted that prices need not reflect the costs of production in two instances: in international trade and domestically under conditions where perfect competition does not exist. Price is also responsive to demand. He concluded that prices and real costs, as defined by many early writers, differ, and international trade, which is based on comparative costs, is governed by money rather than real costs. Cairnes' emphasis on productive conditions focused attention on one of the inadequacies of the Ricardian model. Further treatment of these particular problems was undertaken by Taussig.

*Alfred Marshall* Much of the success in modernizing the foundations of international economic theory is attributed to Alfred Marshall (1842-1924). His most famous work, *Principles of Economics*, represented an endeavor to improve upon and to synthesize the cost theories of the Classical School and the utility theories of the Austrian or Psychological School.<sup>9</sup> The theory of value was one of Marshall's major concerns. According to Marshall, both supply and demand determine price—which is the measure of value. This analysis was applicable both to domestic and to international exchange.<sup>10</sup>

By lumping all of the exports and imports of a country into what he termed "representative sales of goods," Marshall avoided an exposition of international trade based on two commodities. The commodity composition of a sale could vary, but each one represented a constant quantity of labor and capital. Hence his analysis reflects real costs, but it does not embody a labor theory of value.

<sup>9</sup> Marshall, Alfred *Principles of Economics* Eighth edition London Macmillan and Co., Ltd., 1925

<sup>10</sup> Marshall's analysis of international trade is presented in his *Money, Credit and Commerce* London Macmillan and Co., Ltd., 1933.

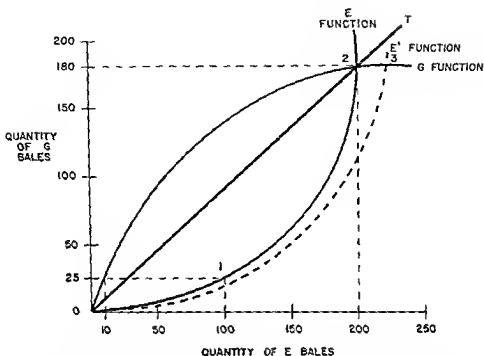
The nature of Marshall's analysis can be illustrated by a graphic demonstration as shown on Chart XV.1. Marshall examined two countries, E and G. He assumed that one produces and is willing to export E bales of representative goods; the other produces and exports G bales. The quantity of E bales is denoted on the horizontal axis; G bales, on the vertical axis. The E and G functions, which might be termed reciprocal-demand or offer curves, indicate how much each country is willing to give up in order to obtain varying amounts of the other country's products. At any point on either the E or G function, the volume of products demanded from the other country is, at the same time, the amount of domestic products supplied. That is, at any point on the E reciprocal-demand function, it is possible to determine the number of E bales country E is willing to relinquish for a specified number of G bales. For example, at point 1 on the E function, country E is prepared to supply 100 E bales in order to obtain 25 G bales from country G. Similarly with the G function, any point on this function designates the number of G bales that country G is willing to give up for a specified number of E bales.

Any given point on either function is assumed to represent internal equilibrium for that particular country where its production for domestic and export purposes is in equilibrium with the given volume of imports. A movement along a function indicates that the commodity composition of each bale has probably changed even though the labor and capital content for each has remained fixed. A shift along a function also shows that a country's internal production has changed to correspond with a different level of imports. But only at that level where the two functions intersect are *both* countries in external equilibrium.

Assume that country E is at point 1 on the E function. At this point its internal production and demand are such that it is willing to release 100 E bales to get 25 G bales from country G. However, country G also has a strong demand for the other country's exports and demands but 10 E bales for 25 of her G bales as indicated by the G function. Therefore the two countries are not in external equilibrium.

As we move upward and to the right on both functions, each country's demand for imports becomes more compatible with the other country's supply of exports. The two functions intersect at point 2 where country E is willing to surrender 200 E bales to obtain 180 G bales and country G gives up 180 G bales to obtain 200 E bales. Both countries are in external equilibrium, both are also in internal equilibrium since each one has remained on its respective function. The terms of trade are determined at this position of equilibrium and are indicated by the slope of a line from the origin through the intersection of

✓  
CHART XV.1  
MARSHALLIAN RECIPROCAL-DEMAND FUNCTIONS



The E function represents country E's demand for G bales as well as its supply of E bales. The G function represents country G's demand for E bales as well as its supply of G bales. The terms of trade are indicated by line T which intersects the origin and the intersection of the E and G functions. With an increase in demand by country E for G bales, the two functions intersect at point 3 and new terms of trade are established.

the E and G functions, line T on the graph. The terms of trade are 180 G bales for 200 E bales or 9:10.

The Marshallian reciprocal-demand curves are also useful in showing how the terms of trade might shift. Assume that consumers in country E increase their demand for G bales as a consequence of a change in tastes and are willing to give up more E bales to get G bales than previously. This is represented by the shift of the E to the E' function. There is a new intersection of the E' and G functions (point 3) and a change in the terms of trade which become 180 G bales for 220 E bales or 9:11. The terms of trade have become more favorable for country G and less for country E.

Marshall's analysis combines supply and demand in determination of prices in international trade. It avoids the over-simplification which

arises from the use of the labor time or cost approaches through the inclusion of both labor and capital as costs of production and takes domestic production into consideration in determining external equilibrium.

F. W. Taussig. Further modification of the principle of comparative costs are provided by F. W. Taussig (1859-1940).<sup>11</sup> According to Taussig, perfect occupational mobility does not exist in a country. He held that the price of goods and services may not be proportional to the quantities of labor embodied in a product because of non-competing labor groups and concludes that trade is governed by relative labor costs rather than by labor time. Despite his analysis, Taussig expressed the opinion that in most instances little difference results if the principle of comparative costs is based on labor time or if it is based on labor costs. He believed that this is the case because the relative structure of non-competing groups in a country is similar to the structure in other countries. Taussig also reasoned that interest on capital must be included along with wages as a cost of production. While he recognized interest as an element of expense in production, he stated that it has no effect on international comparative cost ratios because, where it is added uniformly to other expenses, relative price structures are not altered. Since capital expenses are normally a small share of total costs, Taussig maintained they have little effect on comparative costs. He indicated that rent should not be included in the calculations of cost because it is a differential representing variations in the productivity of land. Rent, which is a price-determined rather than price-determining element, equalizes productive expenses.

### Opportunity Costs

Gottfried Haberler also endeavored to improve the theory of international trade by an important shift in assumptions and analysis.<sup>12</sup> Haberler recognized that the major weakness of the principle of comparative advantage was its use of a labor theory of value. Consequently, he substituted opportunity costs in the place of labor costs as the basis for comparative advantage.

*The nature of Haberler's analysis.* Haberler concluded that the price of an article is not necessarily closely related to the amount of labor which it embodies. Since the factors of production can be employed in alternative pursuits, he reasoned that the exchange ratios of

<sup>11</sup> Taussig, F. W. *International Trade*. New York The Macmillan Co., 1929.

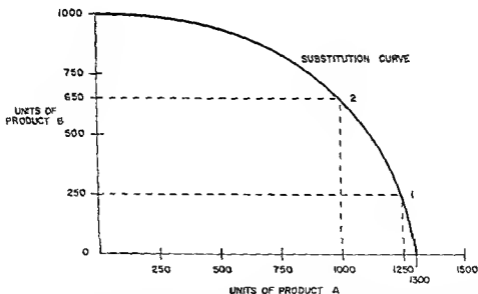
<sup>12</sup> Haberler, Gottfried. *The Theory of International Trade*. London William Hodge & Co., Ltd., 1936, pp 175-189.

commodities are proportional to the costs represented by alternative outputs or other opportunity costs. The cost of producing an article is equivalent to the value of other commodities foregone or given up in order to produce the first article.

Haberler suggested that an economy might produce either commodity A or B. On Chart XV.2, the quantities of B which can be produced are represented on the vertical axis and those of A on the horizontal axis. The substitution curve, which is comparable to a production-possibility curve, represents combinations of two articles which an economy might create. As the chart indicates, a country can produce 1,000 units of B, 1300 units of A or various combinations of both. One combination would be represented by point 1, where 1,250 units of A and 250 units of B could be created and another at point 2, where 1,000 units of A and 650 units of B can be produced. Any point on the substitution curve represents a combination of A and B production possibilities.

CHART XV 2

HABERLER'S SUBSTITUTION FUNCTION INCREASING COSTS



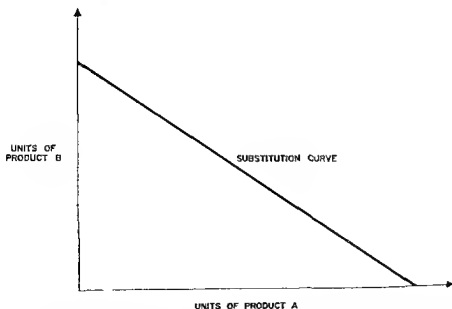
The substitution curve shows various amounts of two products which can be produced by an economy. As the economy produces more units of commodity A, fewer units of B can be created. The cost of producing any article is equivalent to the value of other commodities given up to produce the first article. The substitution curve is concave to the origin, indicating increasing cost conditions. As more units of A are produced, the creation of an increasing number of units of B must be foregone for each unit of A produced.

At any given point on this curve, as more units of A are produced, fewer units of B can be made and vice versa. The production of one article requires sacrificing the production of the second and the value of an additional unit of one product is equivalent to the value of the other commodity which must be foregone to produce the first article. Assume that the economy is at equilibrium on point 1 (1,250 units of A and 250 units of B). Next, assume that there is a slight change in demand for commodity A. Consumers want one more unit of A but discover they must forego about two units of B. The chart indicates what Haberler termed the "substitution ratio." One unit of A is equivalent in value to two units of B with a substitution ratio 1:2 which becomes the market exchange ratio.

*Nature of cost conditions.* According to Haberler, increasing cost type of production exists when, as the output of one commodity is expanded, an increasing number of units of the second must be foregone for each additional unit of the first produced. In this case, a change in

CHART XV 3

## HABERLER'S SUBSTITUTION FUNCTION CONSTANT COSTS



The substitution curve is represented by a straight line, indicating constant cost conditions. As more units of A are produced, the creation of a constant number of units of B must be foregone for each unit of A produced.

demand for commodities alters production patterns and affects exchange ratios. It was assumed in the example that one unit of A exchanged for two units of B. Under different demand conditions, or at another place on the substitution curve, the exchange ratio would be other than 1:2. Conditions of increasing cost production are represented by a substitution curve which is concave to the origin.

The constant cost type of production is represented by a straight-line substitution function, as shown in Chart XV.3, where exchange ratios remain constant regardless of shifts in demand. Decreasing cost conditions, as shown in Chart XV.4, are represented by a substitution function which is convex to the origin. A shift in domestic demand or a movement from one point to another on the substitution function will alter domestic price ratios.

*Implications for the principle of comparative costs.* Haberler believed that his analysis could be integrated into the theory of international trade because the exchange ratios of commodities are equal to their substitution ratios and that the labor theory of value could be discarded. For example, on the basis of opportunity costs it might be assumed that:

In country I, one unit of A exchanges for 1.5 units of B.

In country II, one unit of A exchanges for one unit of B.

These exchange ratios would be substituted for those based on either labor time or labor costs. The remainder of the principle of comparative costs would remain intact. Haberler thus concluded that the comparative cost theory of international trade is valid even without the labor theory of value and its over-simplified assumptions.<sup>13</sup>

### Mutual Interdependence Theory

Despite efforts to bring the principle of comparative advantage closer to reality, it remained subject to persistent criticism. One of the more constructive critics was Bertil Ohlin who introduced the mutual

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<sup>13</sup> Haberler's substitution function has been combined with community-indifference curves to show the net gain available to a country through international trade. In purely domestic trade, an economy would be on the highest indifference curve which is just tangent to the substitution curve. But as a country engages in international trade, the total output available increases, permitting it a still higher indifference curve. One of the major objections to this analysis relates to the validity of community indifference curves. For a discussion of the application of indifference curves to Haberler's opportunity cost approach, see Viner, Jacob *Studies in the Theory of International Trade* London. George Allen and Unwin Ltd, reprinted 1955, pp. 518-526.

assumption that value was determined by costs of production and the assumption that labor was immobile between nations. He maintained that trade between nations is merely a special case of trade between regions. Ohlin thus employed a regional approach and defined a region as being an area which was endowed with a unique set of productive factors. He believed that the causes of trade are related to regional factor endowments and that trade between regions is similar to that between nations. Regional trade can be examined to determine the nature of trade because relative differences in factor endowments provide the basis for cost differences.

Ohlin's analysis stressed the mutual interdependence of factor and commodity prices, income, trade and factor movements. A change in one has a direct or indirect impact on one or all of the rest; it is not realistic to examine one without considering all others. Such an approach is termed a general equilibrium analysis in contrast to a partial analysis because *all of the relevant variables are included*. Trade and prices between regions are determined by foreign and domestic demand and supply. But all prices, including the rate of exchange, in all regions, have an influence on trade. Conditions of increasing and decreasing returns also affect the volume and composition of trade.

*Reasons why nations trade* The immediate cause of international trade lies in the fact that some goods can be purchased at lower prices from external sources than their internal cost. In each region, prices of factors and of commodities are determined by demand and supply. Demand and supply, in turn, are influenced by desires, incomes, the quantity of factors and the physical conditions of production. The inequality of relative prices is a necessary condition for trade, and the reasons why products in various regions have different prices must be discovered.

In his attempt to explain why variations in relative prices arise, Ohlin referred to two circumstances. The first is the unequal endowment of the agents of production—land, labor and capital—in different regions of the world. The second is the varying proportions of these factors which are embodied in different commodities. Ohlin concluded that a region will produce and export goods which embody the relatively plentiful factor, it will import articles which embody large quantities of its relatively scarce factor. An area which is relatively abundant in labor and scarce in capital is likely to have a comparative advantage in the production of goods with a high labor content and to be inefficient in capital-intensive production. Free trade enables a region to use its available factors most effectively and thus to expand total production.

*Effects of trade.* Trade between regions tends to equalize the prices of identical commodities everywhere, with allowances for transportation costs. Furthermore, as a country exports products incorporating the relatively abundant factor, demand for the factor increases; with increased imports, the relative demand for the scarce factors declines. Thus the difference in the relative scarcities of factors is reduced and factor prices tend toward equality among trading regions. The tendency toward equality occurs as trade enables production to adapt itself to the geographic availabilities of factors. Transportation costs and physical restrictions often preclude complete price equality of factors and of commodities.

Whereas Ricardo assumed factor immobility between nations, Ohlin recognized that there is at least partial mobility. He believed this was significant because under some circumstances the movement of productive factors may preclude the need for an international exchange of goods and services. Under other circumstances, factor movements may serve to stimulate commodity trade.<sup>15</sup> An agent of production, with the exception of land, will tend to migrate from areas where it is abundant or its returns low to those where the factor is scarce or its returns high. Factor mobility tends to equalize relative factor endowments and to make prices of both productive factors and commodities move toward uniformity in different regions. In this manner, free factor migration may substitute for commodity trade.

The international movement of productive factors and of commodities is closely interrelated. Free international trade partially or completely eliminates the inducement for factor migration by causing commodity and factor prices to move toward equality among trading areas. However, unrestricted trade alone cannot completely equalize factor prices.

Early writers assumed a labor theory of value; Ohlin recognized that all factors of production contribute to the creation of value. The unequal endowment of factors produces differences in costs and stimulates international exchange. Demand conditions must be examined in conjunction with supply in the determination of the values involved in *both internal and external exchanges*. *Interregional trade* is conditioned by the supply of the factors of production, their relative scarcities in relation to demand, as well as the demand in each region for the goods of other regions

<sup>15</sup> For example, a mass movement of Swiss watch-makers to the United States might reduce the need for the import of watches from Switzerland. But if skilled workers migrate to an underdeveloped country, aggregate income in this country may increase and cause an expansion in demand for imports.

## Summary

The early Classical writers were concerned with obtaining the best allocation of economic resources. Adam Smith, David Ricardo and John Stuart Mill provided theoretical models to demonstrate how the world would benefit as a consequence of unrestricted international commerce. Smith's contribution was the demonstration of the benefits of *laissez faire* and the international division of labor. Ricardo advanced the principle of comparative costs. Mill examined and clarified problems relating to the terms of trade and gains from trade. Although these propositions were regarded as close approximations to a correct theory, the assumptions on which they built their theories were often at odds with reality and were subjected to criticism, modification and refinement by Senior, Cairnes, Marshall, Taussig, and others. Haberler and Ohlin presented general-equilibrium models to demonstrate a more comprehensive theory. Ohlin's mutual interdependence theory has received widespread acceptance. It not only provides an adequate and realistic explanation for the causes of trade but it is also a complete theory in the sense that all relevant variables are embodied in the analysis.

The principle of comparative costs in its modern form, the mutual interdependence theory, is a basic tool for the analysis of international economics.

## QUESTIONS AND PROBLEMS

- 1 According to Smith, international trade is based on absolute advantage; according to Ricardo, comparative advantage. Explain the difference between these two concepts.
- 2 According to Smith, free trade promotes an international division of labor. Why is this the case, and what is to be gained through international specialization?
- 3 Ricardo assumed that labor tended to be highly mobile domestically, but immobile between nations. Of what significance was this for his theories of domestic values and international trade?
- 4 Ricardo's labor theory of value and his assumptions relating to factor mobility were challenged by subsequent writers. Indicate the modifications which have been made relative to these two aspects.
- 5 According to Mill, how could the gains from international exchange for any trading country be determined?
- 6 The writings of Ricardo, Mill and Ohlin show the benefits derived from unrestricted trade and exchange. Yet most nations have imposed obstacles to free trade. Does this reflect the fact that these economists are not correct? For what reasons do nations prevent the free inflow of goods and services?
7. On the basis of Ohlin's analysis, explain the fact that the United States is a major exporter of capital equipment, and Japan an important exporter of handmade novelties and toys?

8. Discuss Taussig's contributions to international trade theory.
9. Ohlin's presentation has been described as a general equilibrium analysis. What does this mean? Is this a more realistic approach than partial equilibrium analysis?

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## The Adjustment of International Economic Relations

Jean-Baptiste Say, one of the founders of the science of economics, was a strong partisan of laissez faire and the rule of natural economic laws as the following passage from his works indicates:

" . . . one has for too long now imagined that the social order is entirely the effect of skilled application (*art*), wherever this order reveals imperfections, it is held to be due to a lack of foresight on the part of the legislator or to some neglect on the part of the public official (*magistrat*) charged with the supervision of this complicated machine. From this idea, plans for imaginary societies were born such as the *Republic* of Plato, the *Utopia* of More, the *Oceana* of Harrington, etc. Each one thought it possible to replace a defective organization by a better one without realizing that there is a nature of things in societies which does not depend at all upon the will of man and which we will never know how to regulate arbitrarily."

Say did much to further the postulate that economic order is controlled by the action of natural laws and that it functions better when free of man's intervention. A corollary of Say's postulate is that there is a tendency for economic forces to move into a state of equilibrium. One type of equilibrium, that between demand and supply for foreign exchange, is shown on Chart IX 1 in chapter 9. At the equilibrium point we have a natural or market price as distinguished from an artificial or man-made price.

*Economic theory and international adjustment.* As far as international economic relationships are concerned, theory holds that a nation's external economy tends to strike a balance, that through the play of economic laws, transactions move toward an equilibrium. This equi-

<sup>1</sup> Say, Jean-Baptiste, *Cours Complet d'Economie Politique Pratique* Brussels: H. Dumont, Libraire-Editeur, 1837, p. 5

librium, in an open economy where economic forces are given free play, is attained more or less automatically.

Balances of payments afford a convenient means of analyzing the equilibria of international relationships. They show, through surpluses and deficits, when a nation's external economic relations are, and are not, in balance; they indicate the sources of disequilibrium as well as the effects of government and business actions upon the external relations of the economy. In addition, they afford some indication of the nature and size of the adjustment needed to restore the balance.

There are not one, but several, measures of balance of payments deficits and surpluses, each adapted to a given analytical purpose, as shown in chapter 5. For the purpose of analyzing the external economic relationships of the United States, equilibrium may be defined as a state where there has been no change in its holdings of gold and in dollar liquid balances owned by foreigners.<sup>2</sup>

Balance of payments disequilibria arise where a nation's international payments exceed its receipts or where its receipts exceed its payments. More specifically, a country's balance will be in disequilibrium when its imports of products and services and its outflows of unilateral transfers and capital exceed its exports of goods and services and its inflow of unilateral transfers and capital. Such a situation arose at the end of World War II for many of the belligerents, when they had great demand for imports and their productive machine had not recovered to the point where they were able to supply sufficient exports to pay for them. Changes in the structure of production also bring about imbalance. Another cause arises from shifts in domestic price levels. Since price movements often occur simultaneously in several different countries, it is not the absolute change, but the relative price movement among the several nations which is significant.<sup>3</sup>

Balance of payments equilibria may be restored by external or internal means, or by a combination of both. Since internal means of restoring balance are discussed in other disciplines such as those dealing with money, credit, banking and the business cycle, this chapter emphasizes the role of external forces.

<sup>2</sup> As explained in chapter 5, most foreign governments, since they use foreign exchange and gold as important parts of their banking and international reserves, measure balance of payments equilibria by the movement of their holdings of gold, foreign exchange and foreign government obligations. Where there is no change in these holdings, the balance of payments is in equilibrium.

<sup>3</sup> Cf. Organization for European Economic Cooperation, *The Problem of Rising Prices*, a report published by the OEEC, Paris, May 1961. A brief summary of this report is given in the publication of the International Monetary Fund, *International Financial News Survey*, Vol. XIII, No. 25, June 30, 1961, pp. 193-194.

row limits. The limits of these fluctuations were so restricted that the rates could not perform their function of restoring balance of payments equilibria except for relatively small movements. With the inauguration of the International Monetary Fund in 1946, certain rules governing the par values of the currencies of the member countries came into effect. Article IV of this agreement stipulates that each member shall establish a definite par value for its currency and that its spot exchange rates shall not vary from par by more than 1 per cent. This article further states that changes in the par can only be made to correct an undefined "fundamental disequilibrium." In addition, the Fund Agreement permits changes which do not exceed 10 per cent of the par to be made without the consent of the Fund but requires those amounting to more than 10 per cent to be approved.

These restrictions upon the free movement of exchange rates operate to prevent the rates of the members of the Fund from exercising their function of automatic adjusters of balance of payments disequilibria. The permissible 1 per cent market variation is too restricted to adjust any but the smallest balance of payments disequilibria. Wider ones are not automatically adjusted, and positive action must be taken by the authorities of the member countries to change their rates to attain equilibrium. As long as the provisions of Article IV of the Fund Agreement remain in effect, the rate of exchange cannot be regarded as an automatic adjuster of substantial balance of payments disequilibria.

### Adjustments by Changes in Prices

The theory that balance of payments equilibria are restored by price movements takes its roots in the price-specie-flow mechanism outlined in chapter 7. Where a country has a surplus on its balance of payments it accumulates holdings of foreign exchange. Since these holdings constitute a part of the banking reserves of many countries, the inflow of exchange works to increase the lending power of the banking systems and to permit an increase in the amount of money and credit in circulation. If there is less than full employment and if resources are not fully utilized, additions to the circulation serve to stimulate production. However, where there is full employment and the resources are completely used, the increase in monetary circulation serves to bring about an increase in prices. If prices increase, exports become more expensive and imports relatively cheaper. Exports will then decline, imports increase and the balance of payments will move from a surplus position to equilibrium.

Where a nation is experiencing a deficit, the opposite effects are

noted. The reserves of foreign exchange decline, the lending power of the banking system decreases and the quantity of money in circulation is reduced. Unless output decreases at about the same rate, prices fall, exports prove less expensive, imports relatively dearer. As a consequence the deficit is reduced, and the balance of payments moves toward equilibrium.

There is another theoretical aspect of the role of prices as a restorer of balance of payments equilibrium. Where a nation is experiencing a deficit, it tends to import more goods and to export fewer. It also may be continuing to produce the same volume of goods for both the domestic and foreign markets. Goods tend to "pile up," inventories to increase. Unless the money and credit in circulation grows correspondingly, prices are likely to fall, imports to decline, exports to increase and the balance of payments equilibrium to be restored.

Conversely, where a country has a surplus, it is importing less than it is exporting. There is a tendency for inventories of goods to be depleted and, unless there is a corresponding decline in the amount of money and credit in circulation, prices may rise. This rise would operate to discourage exports and encourage imports, thus drawing down the surplus and bringing the balance of payments to move toward equilibrium.

Several conditions must prevail before balance of payments disequilibria can be corrected by price movements. Monetary authorities must allow the inflows and outflows of foreign exchange banking reserves to be followed by increases or decreases in the total volume of money and credit in circulation. However, many nations employ a variety of both quantitative and qualitative controls over credit and banking so that changes in banking reserves will only affect the amount of money in circulation when the authorities permit them to do so.

Another condition is that full employment and resource utilization must exist if currency changes are to be reflected in price movements. Currency inflows can only affect prices where no further expansion in production is possible. A third condition requires industry and agriculture to continue to produce at the same level after foreign markets for their products have declined. Agricultural authorities in many nations control the amount of crops, and industries commonly adjust the volume of their output to the size of their markets, both domestic and foreign.

The controls used by both government and business do not always permit prices to adjust balance of payments disequilibria. Price, therefore, is not an *automatic* adjuster of balance of payments disequilibria but only a *mechanism* by which equilibria may be attained under certain conditions.

## Adjustments by Changes in the Rate of Interest

When currency flows into a country with a balance of payments surplus it increases the supply of loanable funds and, unless there is a corresponding increase in the demand for funds, the rate of interest may decline. Investors, faced with the prospect of declining interest yields in balance of payments surplus countries, seek investment opportunities abroad where the rate of interest may be higher. Capital is likely to flow to countries, among others, which are experiencing a deficit on their balances of payments and which face a shortage of loanable capital because their out-payments are exceeding their receipts of funds. This outflow may cause, in its turn, a relative shortage of loan capital, may bring their interest rates to rise, attract funds from abroad, and aid in restoring a balance of payments equilibrium.

With the growth of managed and partially-directed economies, however, the rate of interest has seldom been allowed to fluctuate freely, i.e. to be established solely by the play of market forces. Governments and central banks, as a part of their programs of economic management, control or influence the rates of interest which are then prevented from playing their role of automatic adjuster of balance of payments disequilibria.

In addition, the receipt and payment of funds as a result of surpluses and deficits are but one of many forces acting on the rate of interest, and other forces often prove the stronger. For example, when the United States had substantial deficits on its balance of payments in 1959 and 1960, the market rates of interest in the United Kingdom and some European countries were at times higher than its rates. Capital flowed from the United States to these countries in spite of the balance of payments deficit, and this outflow contributed to making the United States deficit still larger.

Although the rate of interest may not always operate automatically because of government intervention and the play of capital market forces, interest rates have often been employed by governments to aid in restoring balance of payments equilibria. When faced with a balance of payments deficit the Bank of England often raised the bank rate to attract foreign capital in view of halting the outflow. Conversely, when there was a surplus, the Bank frequently lowered its rate to reduce the currency inflow. Other countries, including the United States, have from time to time controlled the rate of interest to aid in attaining both domestic and international goals.

At times there is a conflict of interest between domestic goals, which demand a low rate of interest, and foreign objectives which

indicate that a higher rate is preferable. In such cases either the domestic or the foreign considerations prevail, the external or the internal economy is sacrificed, as the case may be. Given the widespread control of the rate of interest by governments, its role as an automatic adjuster of balance of payments disequilibria is a latent, rather than an active, force in international economic life.

### Adjustments by Changes in Income

Jean-Baptiste Say, the author cited in the opening paragraph of this chapter, promulgated the law of outlets. According to this law, goods exchange against goods. Money does not enter into the transaction but merely plays the role of the measure of value and medium of exchange. It is but an intermediary, and is not desired for itself but only for the things that it will buy. This concept leads to Say's theory of the circuit flow of money which holds that there is a constant sequence of the formula  $\text{goods} \rightarrow \text{money} \rightarrow \text{goods} \rightarrow \text{money} \dots$

This over-simplified view of the role of money in an economy was widely accepted until the appearance of Lord Keynes' two epoch-making works, *The Theory of Money and Interest* (in 1931) and the *General Theory of Employment, Interest and Money* (in 1936). Keynes' original ideas have been developed and generalized by his followers, and today they are a generally acceptable part of economic theory. According to his views, money, far from being a neutral factor in economic life, performs an important active economic service. In addition, Lord Keynes challenged the concept of the circuit flow of money advanced by Say and carried forward by later economists.

Money, according to Keynes, instead of being merely a measure of value and a medium of exchange, activates the economy as it moves from one holder to another. If an individual spends \$100 on a new radio set, the retail merchant from whom he purchases it has \$100. The merchant might use all, or a substantial part of these funds to meet his payroll, his overhead expenses and to replenish his inventory. The recipients of the retail merchant's expenditures might, in their turn, spend their receipts for a variety of goods and services creating a new group of recipients, who might also spend their receipts for additional goods and services and so on. As it moves in circulation, money puts people to work, increases resource utilization and adds to the national income. According to Say, supply creates its own demand, according to Keynes, demand creates its own supply.

In addition, Keynes denied that the volume of money in circulation remains constant. He pointed out that when a person receives, say \$100, he might save all or a part of it and spend the rest. It is only the income

spent at home that serves to activate the economy. The income that is saved, spent abroad or withdrawn from circulation by taxes, has no such effect. Money is withdrawn from circulation by what Keynes termed *leakages*: savings, imports and taxes. Money is added to circulation through *injections*: consumption, investment, exports and government spending.

Further, the addition of purchasing power to the circuit flow tends to increase national income at a multiple of the value of the addition or the injection. The subtraction of purchasing power from the circuit flow tends to reduce national income by a multiple of the subtraction or leakage. This action is a multiple of the injection or leakage because of the effects of the added or subtracted purchasing power as it moves in circulation. It is spent and re-spent, and each time it is spent it increases output and the utilization of resources including manpower. When it leaks out of circulation, output and resource utilization are similarly reduced. Of course, if all resources are fully utilized, additional injections of purchasing power cannot increase resource utilization or output, in this case the additional increments serve to raise prices. Since the Keynesian analysis explains multiplied shifts in national income, economic changes occasioned by the leakages and injections are termed *multiplier effects*.

According to the expenditure approach to income analysis, there are four sectors: consumers, business, government and the rest of the world. National income is represented by the formula:

$$Y = C + I^* + I' + G$$

where  $Y$  represents national income,  $C$  consumers' purchases,  $I^*$  domestic investments,  $I'$  foreign investment (or the algebraic sum of the exports and imports of goods and services) and  $G$  represents government expenditures. National income is composed of the expenditures of each sector for finished goods, expenditures for intermediate goods are omitted to avoid double counting.

*The multiplier effect on the domestic economy* According to the Keynesian multiplier theory, an additional injection of \$100, for example, into the circuit flow of income by means of increased expenditures of any of the sectors will have a *secondary effect* and result in an increase in national income of more than \$100, due to the way in which this injection activates the economy. If all of the income received were spent, national income would increase by an infinite amount. But all of it is not spent. Some of it leaks out of the circuit flow via savings, imports and taxes. The actual multiplier can be computed by equating the injections against these leakages.

In order to understand the multiplier effect, first consider a highly simplified example showing its operation in the domestic economy where there are but two injections. Then:  $Y=C+I$ , where  $Y$  stands for national income,  $I$  investment and  $C$  consumption. Keynes believed that consumption is a relatively stable function of income and that changes in investment are brought about by factors other than income. In this simplified example, under the Keynesian assumptions, the only changes in national income will be occasioned by shift, in investment. The income total of wages and salaries, rent, interest and profits is equal to the amounts spent on consumption and investment goods.

Savings are defined as that part of income which is not spent. Hence  $Y=C+S$ , where  $S$  represents savings. Where an economy is in equilibrium, savings and investment are equal. This may be expressed in the formula,  $C+I=C+S$ . It should be noted, however, that savings and investment do not necessarily take place simultaneously and that they are generally effected by different persons or institutions.

If there were no unemployment and all resources were fully employed, an injection would be likely to raise prices, since production could not be increased and the higher income would be bidding against a maximum supply of goods and services. In the following examples, it is assumed that there is sufficient excess capacity so that an increase in production can take place without raising prices.

The multiplier can now be defined as the multiple by which income changes with a given shift in investment or:

$$k = \frac{dY}{dI}$$

where  $k$  represents the multiplier and  $d$  the change in the function which it precedes. If investment changes, income shifts by a multiple because of the effects of all the subsequent spending and re-spending on consumption. The amount saved leaks out of the circuit flow and does not serve to increase national income. The amount of income saved is determined by the marginal propensity to save (MPS), which is defined as the change in saving associated with a change in income and is expressed.

$$MPS = \frac{dS}{dY}$$

The amount of income spent or consumed is measured by the marginal propensity to consume (MPC) which may be defined as the change in consumption associated with a change in income. Taken together, a change in income must equal that of consumption and savings

so that:  $MPC + MPS = 1$ . Under conditions of domestic equilibrium, the amount of income must increase sufficiently for savings to equal the change in investment. *Since the change in savings is a fraction of the change in income, the reciprocal of this fraction is the multiplier.* Algebraically, the value of the multiplier is:

$$k = \frac{dY}{dI} \quad \text{or} \quad k = \frac{1}{MPS}$$

Hence if it is assumed that investment increases by \$100 with the MPS equal to one-fourth, or 0.25, the multiplier will be:

$$k = \frac{1}{0.25} = 4$$

The change in income, or  $dY = k \times dI$ , will be  $Y = 4 \times 100 = 400$ . Since the MPS is one-fourth,  $S = 0.25 \times 400 = 100$ . National income has been increased by \$400 and the increase in savings is equal to the change in investment of \$100, as shown on Table 16.1.

The size of the multiplier depends, under these assumptions, upon the amount consumed of any increment of national income. If the portion consumed is large, then the part not consumed, savings, is a small fraction of income and the reciprocal, or the multiplier, is large. The greater the expenditure on goods and services, the higher the national income. From this point of view, injections in the circuit flow of money, consumption and investment, increase the national income; the leakage, savings, decreases it. When the total of the marginal leakages equals the total of non-consumption injections, there is no longer any stimulus to further increases in income.

*Succeeding increases in investment.* In the preceding example, a single stimulus, an increase in investment, was assumed. Such an assumption, of course, is not realistic because investment is generally a continuing process, and one such injection is likely to be followed by others. Table 16.2 shows the effects of a series of injections of \$100. In the case of a single increase in investment, which was not sustained in the succeeding periods, the increase in income stopped when the leakage, savings, became equal to the increase in the original injection, investment. In the case of an injection for all of the periods, income increases in each, but at a diminishing rate, because of the leakage through savings. With an injection for each period, the new ones add to the income already generated in the previous periods. If the rate of increase in injections is constant, eventually the total leakages will become equal to the amount of investment in each period. While the

TABLE 16 I

DOMESTIC MULTIPLIER  
SINGLE INCREASE IN DOMESTIC INVESTMENT

Period	Increase In Savings, dS	Increase In Consumption, dC	Increase In Investment, dI	Increase In National Income, dY
1	—	—	100	100
2	25	75	—	75
3	18	57	—	57
4	15	42	—	42
5	10	32	—	32
6	8	24	—	24
7	6	18	—	18
8	5	13	—	13
9	3	10	—	10
10	2	8	—	8
Total Approaches	100	300	100	400

Given an injection of \$100 in investment, with a MPS of 0.25, income increases four times the increment of investment, and savings grow until they are equal to the increase in investment.

TABLE 16 2

DOMESTIC MULTIPLIER  
RATE OF INCREASE OF DOMESTIC INVESTMENT MAINTAINED IN  
EACH SUCCEEDING PERIOD

Period	Increase In Savings, dS	Increase In Consumption, dC	Increase In Investment, dI	Increase In National Income, dY
1	—	—	100	100
2	25	75	100	175
3	43	132	100	232
4	58	174	100	274
5	68	206	100	308
6	77	229	100	329
7	82	247	100	347
8	87	260	100	360
9	90	270	100	370
10	93	277	100	377
Last Period Approaches	100	300	100	400

Assume a MPC of 0.75, MPS of 0.25, with a constant rate of increase of \$100 per period in investment. Income continues to increase in each period until the leakages of each period (savings) equal the increase in investment for that period.

level of income is maintained, it does not continue to increase after it approaches \$400 each period, under the assumption that the MPS is 0.25.

*The foreign trade multiplier* The Mercantilists have been criticized by succeeding generations of economists for their emphasis upon

the values of a favorable balance of trade, or an export surplus, and for insisting upon the importance to a nation of a substantial inflow of specie. It remained for Lord Keynes to point out that the Mercantilists may not have been entirely wrong and that their critics may have over-looked the importance of a steadily increasing inflow of specie. This inflow, according to Keynes, is an injection into the circuit flow of money and tends to augment national income. From the Keynesian point of view, exports are injections, because foreign buyers of the exports must pay for them in the currency of the exporting country, thereby adding to its purchasing power in circulation. Conversely, imports are leakages for the currency of the importing country flows out to buy foreign exchange to pay for the imports. Although Keynes did not develop the foreign trade multiplier, his followers applied the technique of the domestic multiplier to foreign economic relations utilizing Keynes' basic principles.

The problem can be approached by analyzing the effects of an increase in exports upon the balance of payments and national income. Investment can be considered as consisting of two elements, domestic investment,  $I^d$  and foreign investment,  $I^f$ . To simplify the example, foreign investment is defined as the difference between the exports of goods and services, represented by the symbol  $X$ , and the imports of goods and services, represented by the symbol  $M$ .<sup>4</sup> Then  $I = I^d + I^f$ , and  $I^f = X - M$ . If there are idle resources but no savings and no domestic investment, increases in purchasing power will not have an inflationary effect. In this case national income will be equal to consumption plus exports, both injections, minus imports, a leakage:  $Y = C + X - M$ .

A number of statistical studies have demonstrated that there is a close correlation between national income and imports. As national income increases, imports likewise increase, as it falls, imports drop. Imports, just as savings, are a function of income. Nations have a marginal propensity to import (MPM) just as they have a marginal propensity to save (MPS). The marginal propensity to import is defined as the change in the volume of imports associated with a variation in income which can be expressed  $dM/dY$ . The multiplier,  $k$ , is the amount by which income will change if foreign investment  $X - M$ , varies. If

<sup>4</sup> From a technical balance of payments point of view, the excess of exports over imports is not necessarily investment. This difference will generally be represented by increases in the export surplus country's holdings of foreign exchange or decreases in the holdings of its currency by others. Some of the inflow of currency may be invested, other parts may be retained as bank balances. The term investment is employed in multiplier analysis, because the income effect of the export surplus is similar to that of domestic investment.

there is a growth in exports, so that they exceed imports, there will be a movement in income equal to the multiplier times the increase in exports which can be expressed as  $Y = k \times dX$ . In addition, the change in income is equal to the change in consumption and exports or  $dC + dX = Y$ .

To attain balance of payments equilibrium, income must vary sufficiently to bring imports to equal the change in exports. As in the case of savings, imports change at a constant ratio to that of income. The reciprocal of this ratio is the multiplier expressed:

$$k = \frac{1}{MPM}$$

and the value of the multiplier is:

$$k = \frac{dY}{dX}$$

These examples rest upon the assumption that expenditures on imports are the only leakages from the circuit flow of income. In this case, the share spent on consumption serves to increase income until the drain from imports is equal to the stimulus derived from the export surplus.

Table 163 shows the foreign trade multiplier under the assumption that consumers spend one-fourth of any increase in income on imports. To reach a state of equilibrium, income would have to increase four times the original export surplus or imports must rise sufficiently to match the increase in exports. Since imports are a function of income, the level of exports conditions both the equilibrium level of national income and the volume of imports.

*Foreign trade multiplier with domestic savings and investment.* In the previous example for simplicity the assumption was made that there were no leakages due to domestic savings and no domestic injections from investment. If domestic savings and investment are included, the equilibrium position of the economy can be expressed as  $Y = C + I^* + I^s$  and, since all income is either spent or saved, then  $Y = C + S$ . In a balance of payments equilibrium, savings equal both foreign and domestic investment or  $S = I^* + I^s$ . Inasmuch as foreign investment is assumed to occur when exports exceed imports,  $I^s = X - M$ , if  $X - M$  is substituted for  $I^s$ , then  $S = I^* + X - M$ . If domestic investment remains constant, any change in the value of exports must be offset by a corresponding change in imports and savings to attain balance of payments equilibrium.

Because an export surplus is assumed to equal foreign invest-

TABLE 16.3

FOREIGN TRADE MULTIPLIER  
EXPORT INJECTIONS — IMPORT LEAKAGES

Period	Increase In Imports, dM	Increase In Consumption, dC	Increase In Exports, dX	Increase In National Income, dY
1	—	—	100	100
2	25	75	—	75
3	18	57	—	57
4	15	42	—	42
5	10	32	—	32
6	8	24	—	24
7	6	18	—	18
8	5	13	—	13
9	3	10	—	10
10	2	8	—	8
Total Approaches	100	300	100	400

Assume an increase in exports of \$100 with MPC of 0.75 and MPM of 0.25. The export surplus generates income which induces an increase in imports. Income is generated until the leakage, imports, equals exports, and equilibrium is again restored.

ment, if exports increase while imports remain constant, a multiple change in income will occur,  $dY \approx k \times dX$ . The magnitude of this multiple will depend upon both the marginal propensity to save and to import. Both savings and imports are leakages from the circuit flow, so  $MPC + MPS + MPM = 1$ . In other words, a part of any increase in income will be saved, a part spent on domestic consumption and imports. Since the part spent on domestic goods and services goes on creating income until the leakage from savings and imports equals the initial increase in investment, the value of the multiplier can be expressed:

$$k = \frac{1}{MPS + MPM}$$

If the MPS were 0.15 and the MPM 0.10,

$$k = \frac{1}{0.15 + 0.10} = 4$$

An increase in exports of \$100 would result in a fourfold increase in income or  $Y \approx 100 \times 4 = 400$ . Savings represent 15 per cent of this increase in national income, hence  $S = 0.15 \times 400 = 60$ . Imports are 10 per cent of the increase, or  $M = 0.10 \times 400 = 40$  and  $S = X - M$ , so  $60 = 100 - 40$ . Table 16.4 presents a tabulation of these magnitudes

TABLE 16.4

FOREIGN TRADE MULTIPLIER  
EXPORT INJECTIONS — IMPORTS AND SAVINGS LEAKAGES

Period	Increase in Savings dS	Increase in Imports dM	Increase in Consumption dC	Increase in Exports dX	Increase in National Income dY
1	—	—	—	100	100
2	15	10	75	—	75
3	11	7	57	—	57
4	9	6	42	—	42
5	6	4	32	—	32
6	5	3	24	—	24
7	4	2	18	—	18
8	3	2	13	—	13
9	2	1	10	—	10
10	1	1	8	—	8
*	60	40	300	100	400

\* Total Approaches.

Assume an export surplus of \$100, a MPC of 0.75, a MPS of 0.15, and a MPM of 0.10. The export surplus generates income which induces increases in imports, equilibrium is restored when savings equal exports minus imports

Under the conditions illustrated by this table, the national income is in equilibrium, but the balance of payments is in disequilibrium since exports exceed imports. To offset or eliminate this export surplus, international payments must be increased, in the form of imports, unilateral transfers, investment or gold purchases. Conversely, nations with an import surplus, or current account deficit, will need to accept exports, unilateral transfers, foreign investment or to pay out gold.

*Foreign repercussions: tertiary effects.* An export surplus in any country contributes to the increase in its national income and, since the multiplier operates in reverse as well as forward, an import deficit leads to a decrease in income. The amount of the increase or decrease in income will depend upon the size of the surplus or the deficit and upon the magnitude of the foreign trade multiplier.

While a nation's export surplus increases its national income, it works to decrease that of the rest of the world. Conversely, when it has a current account deficit, the national income of the rest of the world increases. Funds flow out of the country with a deficit into those with a surplus and enter the circuit flow of these latter countries, where they operate through the multiplier to increase national income. In the former countries, the funds leak out of the circuit flow via imports, reducing national income in the amounts determined by the size of the deficits and the numerical value of the multiplier.

The impact of income changes of a given country upon the na-

tional income of others is termed the *tertiary effect* or the *foreign repercussions* of these variations. Foreign repercussions will be large or small depending upon the relative volume of trade of each of the trading partners. The impact of income shifts of a country with a small amount of trade upon trading partners having a large volume will not be great. Conversely, where a nation with a large volume of trade conducts foreign business with one having a small volume, the repercussions are apt to prove substantial for the smaller country. Furthermore, the effects of any *one* nation's exports and imports on the *total* trade of the rest of the world are not likely to be substantial.

Foreign trade, as indicated in the preceding paragraphs, does not furnish the only injection and leakage in the circuit flow and it is not the only factor acting upon a country's national income. Domestic investment, taxes, and government expenditures all play roles in the determination of national income. In countries such as the United States, where the domestic economy is far more important than the external, these domestic injections and leakages are more significant in income determination than those of exports and imports. In other countries, such as the Netherlands, where foreign trade looms large in the economy, the foreign trade multiplier is of considerable importance in the determination of the levels of income of the Dutch people.

*Income changes and international adjustment.* Balance of payments disequilibria are adjusted by changes in the level of national income. If a country is running a surplus on its current account, injections enter the circuit flow of income and, if these injections are not completely counterbalanced by leakages, national income will increase by the net amount of the injections (i.e., by the excess of the injections over the leakages) times the foreign trade multiplier. The increased income will be reflected in correspondingly higher imports, thus decreasing the surplus. Where there is a deficit on the current account, national income will decrease by the net amount of the leakages times the multiplier. Its imports will decline and there will be a tendency for the deficit to disappear or to be reduced.

In addition, the foreign repercussions, or the tertiary effects, of income changes must be taken into account. Where a country is experiencing a surplus on the current account, its national income and imports will rise. There also will be a tendency for the national income and imports of its trading partners to decline. These partners will import fewer goods from the country with the export surplus, and the exports of this country are likely to fall off, tending to restore its balance of payments equilibrium. Where a country is experiencing a deficit in its current accounts, the national income of its trading part-

ners rises, increasing their imports and thus working toward the reduction of the deficit country's balance of payments.

Imports which are occasioned by shifts in a country's level of national income are termed *induced imports*; exports which occur as a result of income changes in a nation's trading partners are termed *induced exports*. Those imports which take place more or less independently of income changes, for reasons of price and style, increased industrial demand, innovation, marketability and the like, are called *autonomous imports*. Exports which take place more or less independently of changes in the income levels of a nation's trading partners for similar reasons are termed *autonomous exports*. Only the autonomous imports and exports have an income effect. The effects of the induced transactions are included in the analysis of those of the autonomous transactions and do not generate any additional income effect.<sup>5</sup>

*Effectiveness of income as a balance of payments adjuster.* According to the Keynesian type of analysis, shifts in income serve automatically to correct balance of payments disequilibria, provided they are allowed to operate freely. There is reason to believe that changes in income are a more effective corrective than prices, exchange and interest rates because they are more difficult to control, they are more complicated in their action and resist simple means of intervention.

The principal means of checking the action of income is by the use of import, export and exchange controls. Obviously, where transactions are licensed and only those which are approved take place, income changes will only result from those which occur. Other forms of intervention, either those of the government or private citizens, may operate to reduce income effects or to facilitate them. As existing controls are eliminated or reduced, the balance of payments effects of income changes become more pronounced.

Two important changes have characterized the American and certain European economies since the 1930's. the growth in the per capita national income of the residents of these countries and the shifts in its distribution. Briefly stated, per capita income has been growing; the gap which separated the highest income earners from the lowest has grown narrower, and the earnings from personal effort have shown a tendency to increase more rapidly than those from property.<sup>6</sup>

<sup>5</sup> Other meanings are sometimes assigned the terms autonomous and induced transactions by international economists. For the other definitions of these terms, see chapter 13.

<sup>6</sup> See Kuznets, Simon. *Shares of Upper Income Groups in Income and Savings*. New York, National Bureau of Economic Research, Occasional Paper 35, 1950.

Changes such as these will affect the operations of the multiplier. They increase the propensity to import and to save and minimize the effects of income changes by decreasing the multiplier.

The marginal propensity to consume and to import is probably larger in less developed than in the more developed areas. In addition, savings are likely to be smaller and the multiplier larger in the more primitive countries than in those which are more advanced. The friction arising from imperfectly coordinated economies is apt to be more important in the poorer lands than in the richer, and the multiplier functions less easily in the former than in the latter nations.

### Summary

Since 1946 the balances of payments of most countries have been in a state of disequilibrium and the automatic stabilizers of balances of payments—exchange and interest rates, prices and changes in income—have failed to restore equilibria. The answer to this apparently anomalous situation lies in the fact that these adjusters have been purposely held in check by statesmen. Controlled balance of payments disequilibria apparently better suited the goals of the partially-directed post-World War II economies than the *laissez faire*, natural economic orders of an earlier day.

Many statesmen are no longer willing to see their economies tied to the levels established under *laissez faire*, or to allow them to be subjected to the movements of the natural order. In spite of some of the advantages of competition, many businessmen prefer protection. Exchange and interest rates, prices and income changes operate relatively freely in *open economies* and work but incompletely in *closed economies*.

Although balances of payments are no longer completely adjusted automatically, it is still important to know what the equilibrating forces are and to understand how they operate for they are present in every international economic situation. They may be latent, they may be held in check, but unless checked they will operate. Statesmen who would restrain them must understand these forces if their checks are to perform in a satisfactory manner and good foreign economic policy decisions must be based upon accurate theoretical analysis.

The next section discusses foreign economic policies which, in the practical worlds of statesmanship and business, are of commensurate importance with the theoretical aspects of international economics. The following chapter describes the basic concepts underlying foreign economic policy formulation.

## QUESTIONS AND PROBLEMS

1. Describe the position of Say on the operation of natural laws.
2. Explain what is meant by equilibrium. Why is it used in balance of payments analysis?
3. If economic laws do not always operate completely in the field of international economics, why should they be studied?
4. Explain how balance of payments disequilibria are corrected by movements of the rate of exchange.
5. What role is played by the rate of interest in establishing balance of payments equilibria?
6. How do price changes affect balance of payments equilibria?
7. What modifications did Lord Keynes make in some of the Say's basic concepts?
8. Describe, using appropriate examples, how the domestic multiplier operates.
9. Describe, using appropriate examples, how the foreign trade multiplier operates.
10. How do changes in income operate to create balance of payments equilibria?
11. Define or describe autonomous export, induced export, autonomous import, induced import, closed economy, open economy, natural order, balance of payments equilibrium, foreign repercussions of the multiplier.

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## Foreign Economic Policy: Systems and Concepts

"Well, blind and stupid policy, I will fulfill your wish! I will give you the entire quantity of money which circulated in the nations with which you traded. There it is, all brought together in your place. What are you going to do with it? I see already that you have lost as many foreign consumers as you have ruined and yet you needed them. Lacking these consumers, whom you cannot replace at home, there will be a void in the consumption of your output, a part must remain unsold and become superfluous. This means that your farmers will not only sell a smaller quantity but sell it at a lower price. Since the effect of over-abundance is to cause prices to fall, the price of this output will not rise since it lacks a market"<sup>1</sup>

In these terms Mercier de la Rivière, one of the principal Physiocrats, in 1767 analyzed the results of the beggar-thy-neighbor foreign economic policy of the Mercantilists. In his day, Mercier de la Rivière's words fell on deaf ears, because Mercantilist foreign economic policy, with its notion that one nation could grow wealthy at the expense of its trading partners, dominated man's thought. Time has vindicated de la Rivière and his ideas have gained wide acceptance in the free world. Modern foreign economic policy recognizes that nations do not grow wealthy at the expense of others and that they can best develop by cooperation and mutual aid. Our foreign economic policies have come a long way since Mercier de la Rivière's lines were written, and

they are continuing to shift with man's changing philosophy, outlook, technology and organization of production.

### General Characteristics of Foreign Economic Policy

Foreign economic policy consists of actions, based on principles, dealing with the economic relations among the several nations. Economic policy includes economic actions which are undertaken for themselves as well as those taken in support of some political goal. For instance, loans and grants are sometimes made to help achieve a political goal.

Several groups of forces underlie the formulation of foreign economic policy. The first of these is the domestic interests and objectives of a nation, second, its international goals and ideals, including national security, and third, the ethos of a people, especially its attitudes toward the inhabitants of other lands. The foreign economic policies of the free nations are a mixture of these forces in varying proportions.

Consistency is not a characteristic of foreign economic policy of most nations. Even dictatorships which could be expected, by the nature of their governments, to follow highly centralized and uniform policies fail to achieve consistency. The problems to be solved by the application of policy are often complex. Given the nature of international negotiation, compromise is one of the cardinal rules of policy formulation. There is also often a time-lag between newly-established policies and old laws, regulations and practices. Although the United States is today following a policy of trade liberalization and tariff reduction under the Reciprocal Trade Agreements Act, the Hawley-Smoot tariff (the highest in our history of tariff-making) still remains on the books.

Policy formulation is usually based on a philosophy or philosophical attitude. It may rest upon the notion that the best and most affluent society is one founded upon private enterprise and property, natural liberty, and the freedom of contract. Other systems stem from the postulate that a centrally directed economy, with either free enterprise and property or state-owned enterprise and property, is the best guarantee of human welfare, or that a mixed system—somewhere between these—will yield the optimum results. The systems of the United States, the U.S.S.R. and India are three examples of these different types.

Systems of foreign economic policy are usually national systems. We have United States, British, French, Italian, West German, and many other systems of foreign economic policy. Each national system derives its character from the customs, folkways and mores, as well

as the philosophical and religious beliefs of the people who inhabit the land.<sup>2</sup>

*Nationalism.* Nationalistic doctrines characterize the foreign economic policies of many nations. Such policies have benefit to the country itself and to all or to some of its inhabitants as a primary consideration. The effects of these policies upon other nations or peoples are regarded as of secondary concern. Protective tariffs and other barriers to trade, the screening of foreign investment in an effort to protect or prefer domestic firms, immigration restrictions, preferential treatment accorded nationals and national firms, "Buy American" Acts, discriminatory fiscal measures which tax the property of foreigners at higher rates than those of the inhabitants, restrictions concerning the foreign ownership of land and other forms of property—these and many others are examples of nationalistic foreign economic policies.

Nationalistic foreign economic policies are but one aspect of the larger attitude, nationalism, with which all nations are imbued to a greater or lesser degree. Nationalism is a manifestation on a larger scale of other similar group loyalties such as those to family, clan, tribe, region, school, church, fraternity and club. Nationalism has not always been helpful in terms of higher levels and better patterns of world international economic relationships. At times it has restricted these levels and forced trade into certain patterns. It has often meant retaliation, conflict and war.

In addition, nationalistic foreign economic policies are not always designed to benefit all the inhabitants of a nation. They may redound largely to the advantage of certain groups. A protective tariff may not protect everyone against the pauper labor of a competing country, it may only protect the owners of a given industry. It may not protect consumers. Restrictive foreign investment policies may shield inefficient domestic firms from the necessity of improvement and modernization.

But nationalism has also bestowed benefits. In a sense it is an extension to the national front of domestic policies of individual liberty and free enterprise. Superficially, it might appear that a free enterprise system means rampant self-interest and selfishness, but in practice these systems, appropriately modulated, have meant more in terms of material and spiritual benefits than any other form of state ownership or collectivism has accomplished. Even on the international front, nationalism has proved useful in some respects. Good, bad or indifferent, it is the only system which man presently practices. It would be

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<sup>2</sup> This chapter is devoted to an examination of official foreign economic, or commercial, policy. Foreign economic policy in the private sector, or that made by business, is discussed in chapter 14.

a strange international negotiation wherein each national party pleaded the cause not of his nation but that of nations across the conference table. Just as in individual life, where the self-interest of others holds our own in check, in international economic relations the national impulse of one nation curbs that of others; some advantages are usually gained by each side.

*Nationalism, protectionism and world economic levels.* It might be thought that the reduction of nationalism and the abolition of all barriers to international trade would place nations and all factors of production, wherever they are located, in competition with one another with the result that there would be a leveling of the economies of all countries. Under this leveling, those with high output and income would tend to be reduced and those of the less well-advantaged to be increased. If this were to happen, it is argued, it would be disastrous to the people of the United States and only the less developed lands would benefit. This argument has been repeatedly advanced by the proponents of tariff protectionism and sometimes by the opponents of programs of aid to the underdeveloped areas.

However, if the United States abolished its tariff entirely and traded freely with other nations, such a leveling is not likely to happen. Under the theory of comparative advantage and free trade, nations will continue to specialize and produce those goods and services for which each has a relative advantage. Income, wages, rents, interest and profits would continue to be high in the United States because its economic factors of production and resources would still be employed in high-return activities.

The theory of comparative advantage rests upon the postulate that under free trade the factors of production remain relatively immobile and do not migrate easily from one country to another. Under these circumstances, the United States would continue to enjoy those advantages to which its factoral supply and organization entitled it, since the factors would not migrate abroad and those in other lands would not cross its shores. Free trade would not mean a reduction in the levels of American incomes and output compared to those of the less developed lands. Of course, there would be some changes in industrial and agricultural organization for some industries and farm activities might decline in importance, but there would be no leveling of the world economy.

The effects of international direct investment, however, are another matter. This type of investment means the migration of capital, and often technology as well. Although labor does not move under international direct investment, where United States firms establish branch

and subsidiary plants abroad, American capital and technology are brought to foreign labor whose effectiveness is raised by this movement. Land, with its soil and climate characteristics as well as its spatial relationships, does not move with international investment. But with the international flow of capital and the dissemination of agricultural technology, the economic effects of the physical immobility of land tend to be less significant and it becomes effectively more mobile.

While free trade in goods and services is not likely to result in an international economic level, free direct investment does serve to move economies in that direction. This international equalization could take several forms. It could mean that the economies of the less highly-capitalized nations would be raised while the level of leading capitalistic nations would be lowered, or it could mean that the economies of both would be raised, those of the less developed areas at a higher rate. Of these two forms of international leveling, the latter appears to be the more probable.

It would appear from this analysis that nationalism in its protectionist form has been "barking at the wrong door." In the future, nationalism and protectionism may abandon the fields of trade in goods and services and turn to prohibitory regulation of the free movement of direct investment.

### Types of Foreign Policies

Treatises on international politics and economics commonly divide foreign policy into two broad groups: foreign political policy and foreign economic policy. In its Foreign Service and Department of State the United States government has political officers, who devote their attention to foreign political affairs, and economic officers, who work on foreign economic policy. As a practical matter it is not easy to draw a sharp line separating the two. As suggested in chapter 1, classifications such as these are man-made. They do not exist in the nature of the policies themselves and have but limited validity. Nonetheless, to achieve simplicity in the description and exposition of these subjects, it is convenient to separate foreign economic policy from foreign political policy.

*Foreign economic and political policies* Generally speaking, foreign economic policy has as its objective changes in, or the maintenance of, the production, income and its distribution, or the economic structure of a nation and its trading partners by means of international economic relations. Foreign economic policy may also be defined more specifically as a course of action based upon stated or implied principles designed to affect the international movement of goods, services,

income, unilateral transfers, capital and gold. The principal differences between these two definitions lie in their respective points of emphasis. The first stresses the basic long-run concept, and the second, the immediate and specific objects of the action taken.

Foreign political policy deals primarily with the rights and duties of states, their institutions and instrumentalities vis-à-vis one another as well as with those of the citizens and property located in other countries. It deals also with arrangements designed to maintain, enhance or reduce the power of states in the community of nations; to coordinate or differentiate its laws, institutions and customs with or from those of other nations.

Foreign economic policies are distinguished from political by their principal emphasis or results. Thus a tariff falls in the field of foreign economic policy because its principal emphasis or result bears on the international movement of goods, and the fact that it affects the rights and duties of one state toward another is incidental. A consular treaty is primarily political because it deals largely with the privileges and functions of consular officials abroad, and that it affects the trading relationships of the two countries is only incidental.

Before the rise in importance and significance of psychology, sociology and anthropology, foreign economic policy was believed to be the fundamental upon which all other relations ultimately depended. This is the now discredited economic or materialistic interpretation of history popularized, but not invented, by Karl Marx. All international policies and all history, according to this thesis, are conditioned by economic factors. States, like men, are very simple organisms responding largely to the dual urge of the desire for wealth and power and the avoidance of effort. Discoveries of other social sciences indicate that such an explanation or interpretation of man's conduct is over-simplified. Men and states are highly complex, they respond to a wide variety of stimuli of which economic motives are but one among several. No one knows which is the fundamental force, and it is not important that this be known. What is important is that men understand what they do, whatever the motives, that the effects of what is done are known, preferably in advance, and that people act on information and knowledge rather than upon prejudice or ignorance.

*Kinds of foreign economic policies.* There is a wide variety of foreign economic policies. A complete list would be difficult to draw up and would have but limited validity over time. An action today which has no conceivable foreign policy effects, may have a most important effect with the passage of time. Every day new legislation and the exercise of executive authority serve to change the list. For the

purposes of indicating the more important of our foreign economic policies, the balance of payments affords a convenient method of classification.

### *Policies Affecting the Trade in Merchandise*

#### Tariffs

The Reciprocal Trade Agreements Act, the General Agreement on Tariffs and Trade and trade agreements.

#### Excise taxes

"Buy America" Acts, federal and state

Export and import quotas

Sanitary legislation

Custom laws and regulations

Embargoes

Foreign Trade Zone legislation

Export and import controls

Anti-dumping legislation

Stockpiling

Export and import subsidies

Patent, trademark and copyright laws applied to imports and exports

Agricultural price support and surplus disposal programs

### *Policies Affecting Travel*

Immigration and naturalization laws

Passport and visa laws

Control over communicable diseases

Visitors' taxes and taxes upon accommodations

Quarantines

Income tax regulations

Customs laws and regulations as applied to traveller's effects

Travel restrictions

### *Policies Affecting Transportation*

Navigation laws

Maritime laws

Maritime labor acts

Port and harbor laws and regulations

Shipping documentation regulations

Customs regulations applying to shipping

Laws applying to common carriers

Airline and air traffic laws and regulations

Laws requiring the use of American shipping

Merchant marine acts

Maritime Commission regulations

Shipbuilding programs

Postal laws and regulations

International conventions relating to shipping, navigation and commercial aviation

Laws and regulations of the Civil Aeronautics Board  
Laws and regulations of the Civil Aviation Administration

*Policies Affecting Miscellaneous Services*

Insurance laws and regulations of the several states  
Laws governing the international exercise of occupations and professions  
Labor legislation  
Agreements providing for foreign missions and military establishments abroad  
Conventions governing the status of troops abroad  
Laws and regulations governing the administration of loan and grant programs overseas  
Laws controlling international communications  
Provisions of the Internal Revenue Code relating to the taxation of income of foreign subsidiaries

*Policies Affecting Unilateral Transfers*

Laws applying to religious institutions insofar as they affect their missions abroad  
Laws applying to educational and scientific organizations insofar as they affect their overseas establishments  
Laws affecting remittances of private individuals to foreign residents  
Government foreign aid and technical assistance programs  
Regulations and laws governing pension payments overseas

*Policies Affecting Capital and Gold Movements*

All the monetary and banking laws and regulations of the federal government and the several states  
Foreign funds control laws and regulations  
State and federal corporation laws and regulations  
Laws and regulations administered by the Securities Exchange Commission  
The Sherman Anti-Trust and the Federal Trade Commission Acts together with other anti-trust laws and regulations  
The Articles of Agreement of the International Bank for Reconstruction and Development, the International Monetary Fund and other international financial agencies  
All laws and regulations pertaining to gold  
Conventions, agreements and treaties relating to international capital movements  
Exchange controls  
Investment treaties  
Treaties of Friendship, Commerce and Navigation

The above list is not complete. It has been included to give some idea of the number and variety of laws, regulations, treaties and agreements which formulate and determine foreign economic policy. Since early days, the world has seen many different policy systems which take their roots deep in man's past, and various states have contributed to

modern policies. Those of the greatest importance to modern commercial policy are the systems of the Mercantilists, the several types of laissez faire and the systems of the partially-directed economies of today.

A former, if widely held, view has been that the domestic economy is more or less independent of a nation's external economic relations and that the internal effect of these relations is so small that it may be safely ignored. Since World War II there has been a change in this attitude. The impact of foreign trade upon the domestic economy cannot be measured by statistical magnitudes alone or by percentages which indicate that imports and exports amount to but 4 or 5 per cent of the gross national product. The following chapter describes some of the more important principles underlying United States foreign economic policy, the ways these policies are formulated and applied, and shows how they have been implemented.

## QUESTIONS AND PROBLEMS

- 1 Distinguish foreign economic policy from international economic theory
- 2 In what ways has nationalism affected foreign economic policy?
- 3 Would the adoption of a free trade policy by the United States serve to reduce the level of its wages to that of its trading partners? Why or why not?
- 4 What would the effects be on wages and interest of greatly increased United States direct investment abroad?
- 5 What are some of the relationships between national objectives and foreign economic policy?
- 6 Distinguish foreign economic from foreign political policy
- 7 Explain why so many different laws and regulations have been promulgated governing foreign economic policy
- 8 George Washington remarked in his Farewell Address that the United States should avoid entangling alliances. Should this policy apply today? Why or why not?
- 9 Who ultimately determines foreign economic policy? The people, the legislature or the executive branch of the federal government? Why?
- 10 Select any three features of United States present foreign economic policy and discuss each

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## Foreign Economic Policy: Characteristics and Methods of Formulation

"Dominating our thinking throughout, has been the sobering realization that the policies pursued and the actions taken by the United States in respect to our foreign economic policy profoundly influence the destinies of all the peoples of the world. Our Nation bears an awesome responsibility of world leadership. Though not of our seeking, it is one that we may be fated to bear for a long time to come. If we bear it with understanding, courage, and honor, we can make incalculable contributions to the cause of peace and the advancement of human welfare."<sup>1</sup>

Clarence B. Randall, Chairman of the Commission on Foreign Economic Policy, in January 1954 introduced the *Report* of his Commission with these lines, which reflect both a sense of responsibility and of destiny. This *Report* has had considerable influence upon American foreign economic policy which has followed Herbert Spencer's dictum that progress consists in man's ability to change with the altering circumstances of his surroundings.

### Characteristics of United States Foreign Economic Policies

Great Britain applied prevailing Mercantilist theories to its trade with the American colonies. Industry was discouraged, the colonies were looked upon primarily as sources of raw materials for the motherland and as outlets for its manufactures. The colonists were supposed to trade with Britain and Britain alone. The British Mercantilist system

<sup>1</sup> *Report to the President and the Congress, January 1954. The Commission on Foreign Economic Policy (The Randall Commission). Washington, D. C.: United States Government Printing Office, 1954, p. 1.*

left a negative impression upon the American people which has been reflected in the subsequent development of the foreign economic policy of the United States.

*The Open-Door, non-discrimination and national treatment policies.* After its formation, the first problem facing the foreign traders of the United States was to gain the right to trade with other nations, for commerce with many areas was largely closed to the early businessmen of the new Republic. To meet this situation, the Open-Door policy was developed which affirmed the right of all nations to trade anywhere on terms of equality. Other aspects of early American foreign economic policy supported the doctrines of national treatment and non-discrimination. The former holds that foreigners, their property, businesses and persons should receive the same treatment abroad as the nationals of the country in which they are located, while the latter declares that a nation should not treat the persons and property of one country better than those of another.

*Unregulated trade and competition.* From the outset the United States was largely dedicated to the ideals of laissez faire. In the field of foreign economic policy, laissez faire has meant the freedom of all citizens to trade under a minimum of socially-necessary government restriction and regulation.

In addition, the early colonists feared power, political and economic, in the hands of both government and private citizens. The Republic's tripartite system of government, with its checks and balances, is a manifestation of the distaste for strong government while anti-trust legislation bears witness to the disapproval of private power in the form of monopoly. In the field of international economic relations the United States has held cartels and monopolies to be largely taboo.

*Levels and patterns of income.* With the advent of the New Deal in 1933 and the publication of Lord Keynes' *The General Theory of Employment, Interest, and Money* in 1936, a new element was added to United States policy. This was the realization of the role which the level of national income plays in the welfare of the economy. Where per capita national income is low, the market for the products of farms and factories is proportionately small. When people do not have the wherewithal to buy goods, output, employment, prices and wages are likely to remain below their maximum levels.

It was also recognized that the patterns of income distribution were of importance in determining the activity of the economy as a whole. Where higher incomes go to few people, where the lowest are distributed to a large number and where there is a small middle class, a large fraction of the national income is spent for bare necessities. A

one-sided economy tends to develop. In such an economy the levels of output are apt to be low, employment opportunities restricted, industrial wages and farm returns depressed. During the thirties, the gap between very high and low income groups tended to grow smaller. Earnings from labor also increased more rapidly than did those from property. Income differentials were narrowed and the United States saw the emergence of a large middle class.

The Marshall Plan extended this idea to the international front. Low incomes abroad, it was reasoned, meant low United States exports, poor sources for United States imports and restricted investment opportunities for United States capital and enterprise. This internationalization of the domestic philosophy of the thirties constituted a new development in the field of United States foreign economic policy which has had important consequences.

*Isolationism* In his Farewell Address, Washington warned the nation against entangling alliances. This warning, coupled with the new nation's desire to go its own way, brought American citizens to view their relations with others with a certain degree of detachment. The word *isolationism* has been applied to this attitude, although it may not be a very precise characterization.

This attitude persisted until World War I, when the United States partially abandoned it by participating in that conflict. After the war, the country regained its pre-war predilection for detachment from European affairs. By its reluctance to participate in the League of Nations and its insistence upon repayment of the inter-allied war and post-war debts, the United States again affirmed its intention of going its own way. Defaults on some of the post-war portfolio loans served to reinforce this sentiment. During the thirties the depressed state of the internal economy occupied the attention of the administration, and at that time the nation evinced but little interest in the affairs of peoples in other lands.

*Participation in world affairs* An abrupt change in America's attitude toward other nations was marked by the outbreak of World War II. The United States discovered that it was impractical to lend its Allies the funds needed for the prosecution of the conflict and Lend-Lease was devised. The United States helped to finance the war largely through grants and, to a lesser extent, through loans of property. At the end of the conflict, Lend-Lease settlements left the Allies with but small repayments to make. Whereas World War I debts served to embitter international relations, the Lend-Lease Program was a step toward international cooperation. In addition, at the conclusion of this conflict, the United States did not withdraw from the rest of the world,

as it had done after World War I, but continued to play a leading role in the affairs of the free world.

*Leadership in world affairs.* Many of the inhabitants of the United States relinquished slowly their historic distaste for entangling alliances with strange people in distant lands. The nation was ill-prepared for its new role. It had little experience in this work, and the agencies dealing with it were not well organized to discharge their new responsibilities. The United States has improved its foreign policies and the American public is becoming adjusted to the new responsibilities. Opposition to its role is declining.

The position of the United States does not stem entirely from its prosperity or material position. Even when relatively poor, it was the object of admiration on the part of many foreign peoples as heavy migrations to this country in the nineteenth century attest. The basis of its strength then, as now, was found in the ideals and values for which it stood. Born in revolution, the United States has recognized popular needs and aspirations and has shown willingness to meet new challenges.

No nation is, or ever was, entirely free to make its own decisions. Many of them are necessitated by circumstances. The United States must discuss its policies with friendly nations and with all those with whom it negotiates. Every negotiated policy is a compromise; the United States seldom gets its way entirely.

*Cyclical aspects of foreign economic policy.* The impact of the business cycle is wide and affects almost all aspects of economic and political life. Foreign economic policy is not exempt from these cyclical swings. During the downswings policy is apt to turn more nationalistic and the domestic economy is likely to occupy the center of the stage. When the cycle turns up, perspectives are widened and greater interest is evinced in the affairs of other peoples.

When business is bad, there is a tendency to raise the tariff; the highest tariff in United States history, the Hawley-Smoot Tariff of 1930, was passed during the early years of the Great Depression in the hope that it would improve business. On the other hand, the tariff has been lowered during periods of relative prosperity. The United States is not the only country whose foreign economic policy is partially conditioned by cyclical movements, all nations with economies sufficiently integrated to experience the business cycle tend to orient their policies according to the way in which it swings.

*Partisan aspects of foreign economic policy.* In the past, foreign economic policy, with certain notable exceptions, has been a leading issue of American partisan politics. When the Republicans gained con-

trol, the United States often raised its tariff, when the Democrats were in power, the tariff was frequently lowered. The tariff question was usually a leading issue between these two parties during the campaigns of the nineteenth century. The high tariff acts of 1922 and 1930 were passed when the Republicans were in power, the Hull Reciprocal Trade Agreements Act, with its tariff-lowering provisions, when the Democrats held sway.

The differences between parties, as far as foreign economic affairs are concerned, have tended to grow smaller since World War II. The tariff is no longer the leading political issue which it once was, and the United States has had a bipartisan foreign policy for a number of years.

### United States Foreign Economic Policy Formulation

Foreign policy determination in the United States devolves upon all three branches of the government: the legislative, the executive and the judiciary. The broad framework of this foreign economic policy is principally the work of the Senate and the House of Representatives. The implementation of Acts of Congress is supplied by the executive branch, and their interpretation is in the hands of the judiciary.

*The judiciary.* The judiciary is not ordinarily thought of as a foreign economic policy-making arm of the government, but many of its decisions serve to mold policy. A number of years ago, for example, the Tariff Commission, in an escape clause action, recommended that the tariff on bicycles be raised to avoid serious injury to the American industry. The President, after obtaining advice from several federal agencies, decided to raise the tariff on certain types of bicycles, but not on all types as the Tariff Commission had recommended. The President's decision was challenged in a federal court which held that under the law the President could accept or reject the Tariff Commission's decision as a whole, but could not modify it or accept but certain parts. As a result, the tariff on bicycles was restored to the level which prevailed before the recommendation of the Tariff Commission. The federal court, in effect, made foreign economic policy by its decision.

Laws are held to be unconstitutional or are interpreted by the judiciary. When these decisions deal with laws involving foreign economic policy, the policies are either nullified, affirmed or modified by these decisions. In addition, treaties, regulations and actions of government agencies are subject to the review of the courts. The passport policies of the Department of State, for example, have been modified on several occasions by judicial decisions. Under the doctrines of *stare*

*decisis*<sup>2</sup> and judicial review, the power of the courts has been felt again and again in the shaping of foreign policy.

*The legislative branch.* The basic legislation underlying much, but not all, American foreign economic policy is the work of the Congress. Legislation determines the operations and organization of all departments and agencies dealing with this policy. Many federal programs are but the implementation of Acts of Congress. The appropriation bills, which define the scope and limitations of foreign economic programs, are voted by Congress. Through committee hearings, as well as investigations, the work of these agencies is reviewed and appraised by Congress. In addition, much of what the executive branch does on the international front is partially conditioned by the forecast of possible Congressional reactions.

Foreign economic policy legislation originates in Congress in several ways. Much of it is the work of individual senators and representatives whose experience, factual background and research have convinced them that certain measures are necessary. Some of it originates in the Committees of the Senate and House which hold hearings, make investigations and have special reports prepared for them by both outside and federal agencies. Other legislative foreign economic policy stems from organized groups of citizens, business firms and associations which have an interest in seeing some legislation enacted, oriented in a certain manner or repealed. The executive branch is the principal originator of Congressional foreign economic policy because it proposes and sponsors much legislation which its experience indicates is useful or necessary.

*Executive branch: treaties* Perhaps the greatest liberty enjoyed by the executive branch in foreign economic policy formulation is to be found in its treaty-making powers. Here, no Congressional enabling legislation is needed, the principal requirement is that treaties be ratified by a two-thirds majority of the Senate.

Foreign economic or commercial treaties date from the beginning of the Republic. The first was negotiated with France in 1778. Since that time, about 150 treaties of a general commercial nature have been negotiated and ratified. The earliest treaties were designed to strengthen the economic foundations of the new Republic. During the Napoleonic wars and until the 1860's they emphasized navigation in response to the needs of the then relatively important merchant marine. As indus-

<sup>2</sup> For a discussion of the doctrine of *stare decisis*, see Moore, Russell F. *Stare Decisis—Some Trends in British and American Doctrine*. New York: Simmons Boardman Publishing Corporation, 1958.

trial power of the United States increased after the Civil War, the treaties which followed stressed problems of trade and tariffs. After World War I, they gave more attention to the rights of business and capital following the marked increase of United States direct foreign investments.

These treaties are of a mutual character. The same rights which they confer on United States property and citizens abroad are also granted to the property and nationals in the United States of those countries with which they are negotiated. They embody the principle of national treatment providing for the rights of citizens to enter a country, reside and travel there, to receive the same protection as that accorded to a country's nationals and to carry on the same business activities. In addition, they arrange for compensation in the case of expropriation, equality in taxation as between United States citizens and nationals, and the repatriation of investment profits and capital. These treaties, often called Treaties of Friendship, Commerce and Navigation (FCN) are instruments of prime importance to the activities of private American citizens and firms in their international business and personal relations abroad.

*Executive branch: executive agreements* Executive agreements do not require Senatorial approval but their force as law is not as broad as that of treaties. Trade agreements negotiated under authority of the Trade Agreements Acts and the General Agreement on Tariffs and Trade (GATT) are examples of the executive agreement.

Through its contacts with foreign governments, the Department of State discovers what commodities those countries propose for United States tariff reduction and by how much they would like to see the duties lowered in each case. The Interdepartmental Committee on Trade Agreements (ICTA) analyzes these proposals and prepares a list of United States products, exported to other countries, for which tariff reductions should be obtained in exchange.

The ICTA then determines the tariff changes which it is prepared to accord and to request. An appropriately instructed United States delegation subsequently negotiates with the other participating nations. At the end of the negotiations, an executive agreement is drawn up embodying the tariff concessions granted and received and, when signed by the President, the United States tariff is modified accordingly.

*Executive branch: implementation of Congressional authorizations.* With the exception of treaties, much foreign policy made by the executive branch of the government is done under some form of Congressional authorization. Among the many possible examples of this type of foreign policy-making, the work of the National Advisory Council

(NAC), established by legislative action with the functions which Congress granted it, affords a good illustration.

The membership of the NAC consists of Cabinet-level officials. Among other things, it screens and approves all new loans made by the several government lending institutions. The American Executive Director of the International Bank receives his instructions from the NAC before voting for or against the Bank's loans, and the American Executive Director of the International Monetary Fund must obtain NAC approval before he can speak in the name of the United States. In addition, the Department of Agriculture is obliged to obtain NAC agreement before it can sell farm surpluses abroad in exchange for local currency or on a long-term loan basis.

The actual work of the NAC is done by a staff committee composed of senior employees of the departments and agencies represented on it. This committee analyzes each proposal which comes before it, makes appropriate recommendations and suggests the United States official policy in each case. It is often assisted by technicians from the Bureau of the Budget and the Council of Economic Advisors. Its recommendations are sent to the Council, which makes the final decisions.

*Executive branch. desk officers.* Day-to-day decisions are made by technicians and executives in the several federal departments and agencies, especially in the Department of State. Foreign economic policy formulation work of these officials is of two types: that which arises from the execution of certain specific programs and that which results from information received, or action requested, by the various foreign missions of the United States overseas.

The Trade Missions Program is an example of the first type. Under this program, the Department of Commerce sends Trade Missions composed of American businessmen, under the leadership of a Department of Commerce official, to various foreign countries to meet with businessmen and government officials. They explain American ways of doing business, United States foreign economic policies and the advantages of doing business with the United States. In addition, each Trade Mission endeavors to locate as many international business opportunities as possible and to publicize these opportunities in the United States upon its return.

Although the program is largely autonomous within the Department of Commerce, other departments and agencies are consulted in the preparation and execution of the programs of each Trade Mission. The Trade Mission's desk officers, including those who head each Mission abroad, have been successful in promoting the growth of American

business abroad and, in doing so, they make foreign economic policy at the businessman's working level.

A large number of foreign economic policy decisions are made by government technicians and executives in connection with problems which arise overseas. A country, recipient of United States foreign aid, desires to build some roads with aid funds. The officials of the United States Agency for International Development operations mission located there are approached by the government concerned and the proposition is discussed. The operations mission analyzes the proposal, makes its recommendations and transmits them, through the Department of State, to the Agency for International Development. There the proposal is studied and a decision reached, approving, disapproving or modifying the request. The foreign government is then informed of the decision and steps are taken to put the recommendations into effect.

*Executive branch. position papers* When international conferences are held, the United States delegations attending them must come prepared to take positions on the topics which are likely to arise under the conference agenda.

At a meeting of the Trade Development Committee of the Economic Commission for Asia and the Far East (ECAFE), for example, one of the items on the agenda dealt with the steps which member nations could take to increase their exports. The United States position paper on the item in question was prepared by an economist in the Department of Commerce. It dealt with the desirability of careful inspection of all products before shipment to make certain that they met the contractual specifications in all details, it proposed that commodities be graded before export, that attention be given to proper packing for shipment, and that delivery dates and shipping instructions be scrupulously followed. This position paper was reviewed by the members of a committee established to make the United States preparation for the meeting and it was subsequently read by the chief of the United States delegation at the conference. The United States sends delegations to many international conferences, and hundreds of position papers on a wide variety of topics are prepared each year.

*Foreign missions* The United States maintains a variety of foreign missions abroad. The Department of State is responsible for American embassies, ministries, consulates general and consulates. As a general proposition, these missions handle diplomatic and consular affairs and are the eyes and ears of the United States government abroad. In addition to the missions of the Department of State, other agencies maintain offices abroad for the purpose of carrying out their overseas programs. These are, principally, the operations missions of the Agency

for International Development, which is charged with the administration of foreign aid programs, and those of the United States Information Service, designed to disseminate facts about the country and to maintain libraries and radio services abroad. Other agencies, such as the Department of Agriculture, the Treasury, the Army, Navy and Air Force have attachés at embassies serving both their own agencies and the Department of State. In some large centers, missions to the North Atlantic Treaty Organization and the European Regional Organizations, among others, are maintained.

The foreign missions of the Department of State are responsible for an extensive program of services for the United States government and its citizens. The consular services which they perform include the issuance of passports and visas, the administration of immigrant quotas and the issuance of consular invoices. In addition, they perform a variety of services for Americans abroad, such as witnessing marriages, the certification of births and deaths, the protection of citizens and their property, the repatriation of stranded Americans, the protection of United States seamen, notarial services and re-entry permit extensions, among others. They also furnish information, advice and help businessmen to make business contacts.

The other services furnished by United States embassies and consulates abroad include the representation of the United States government, the negotiation of treaties, executive agreements, conventions and other matters requiring discussion and settlement with foreign governments, representing the United States at international conferences and ceremonies, the settlement of disputes involving the government, supplying interested foreigners with information concerning the United States, the transmission of memoranda and other documents to Washington accompanied by analyses and recommendations, the execution of specific requests for action or for information emanating from Washington.

Reporting and informational services rendered by these missions are of great importance in the formulation and execution of foreign economic policy. These missions report on various aspects of the economies of the countries where they are located. When these reports arrive in Washington, they are duplicated and distributed to those government agencies interested in them. For example, copies of a report on agricultural labor in France are sent to the Departments of Labor and Agriculture, the French division of the Departments of State and Commerce. The optical products commodity man in the Department of Commerce receives reports on the optical industry in various countries together with such other reports as his work might require.

These reports perform an important function in keeping federal technicians and executives informed concerning foreign developments in their fields of work, and they constitute the principal source of foreign information which the country desk officers, commodity men and functional technicians have. The officers in federal agencies whose work has foreign aspects commonly maintain files of these documents conveniently classified for ready reference.

In addition, these reports are used to inform and advise American businessmen and other citizens, to answer letters and prepare memoranda, and some of them serve as the basis of articles and news releases published by government agencies. The foreign trader's publication of the Department of Commerce, *Foreign Commerce Weekly*, is largely composed of materials taken from such reports.

Much of the reported information cannot be made public inasmuch as a substantial fraction of it is classified. These classifications are employed because of the nature of the information, e.g. where the report embodies comment which some foreign governments may consider derogatory, or because the source of the information must be protected. Classified information can, however, be used by federal officials in determining foreign economic policy and it is widely used for this purpose.

These reports are frequently accompanied by supporting documents in the form of publications, catalogs, maps, official reports and memoranda of foreign governments, and their quality is excellent. As a result, American officials dealing with foreign economic affairs are well-informed.

*Other functions of the Department of State.* Some matters are settled in the Department of State by area desk officers, functional and commodity specialists who usually discuss the question with various colleagues. Replies to important action or information requests from the foreign service posts and policy matters are usually submitted for approval by these officers to their immediate supervisor who may in turn take the matter up with still higher authorities including the Secretary of State and the President.

Different Secretaries of State carry out their responsibilities in various ways. All of them generally arrange for daily or periodic briefings on important developments overseas and are shown the despatches which embody information or requests for action which might require their personal attention. In making decisions, the Secretary can avail himself of the services of his own staff as well as specialists in other federal departments and agencies. The State Department staff considers policy matters of the highest importance, plans policy for the

future and endeavors to integrate and coordinate the diverse aspects of American policy.

Before World War II, the Department of State was a relatively small agency. It started to expand during the war and increased in size during the post-war years as the result of increasing international responsibilities of the United States, its desire to do a better job and the inheritance of some international work, formerly performed by other agencies. The Department of State today is a replica in miniature of the whole United States government. It has its own "Departments" of Commerce, Labor, Agriculture, Justice, Health, Education and Welfare; its own Federal Trade Commission, Civil Aeronautics Board and Interstate Commerce Commission, among others. Obviously the wide scope of activities of the Department involves foreign policy-making. An inherent problem is that of assuring that such policy-making, even when in the hands of relatively low-echelon officials, possesses the breadth and depth which present-day responsibilities of the United States demand.

*Public relations and other aspects of foreign economic policy.* Foreign economic policy-making by both the legislative and executive branches of the United States government is profoundly affected by public opinion. Senators and members of the House of Representatives are ever concerned with the opinions of voters on these matters. It is the people acting through their duly elected representatives who ultimately determine foreign economic policy. The executive branch of the government is equally sensitive to public opinion.

This chapter has given greater emphasis to foreign policy determination by the executive than to that made by the legislative branch. It should not be inferred from this emphasis that the foreign policy made by the executive is more important than that formulated by the legislators. But the former is less well-known and accordingly has here received somewhat more detailed treatment. In the following chapter the customs tariff is examined. Traditionally, the tariff has been the cornerstone of United States foreign economic policy but this is less true today than formerly. It nonetheless remains, in the eyes of Americans and foreigners alike, the most important aspect of this policy.

### QUESTIONS AND PROBLEMS

- 1 Explain why the United States has insisted upon the Open Door and national treatment policies.
- 2 Explain why isolationism is less important in the United States today than it was prior to World War II.
- 3 If the United States were to lose its leadership in world affairs and India were to take its place what changes in world policy might occur?

4. What are the strengths and weaknesses of policy-making by (a) the Congress and (b) the executive branch of the government?
5. What are some of the limitations of the executive branch in the field of foreign economic policy formulation?
6. In what ways has the business cycle and partisanship affected United States foreign economic policies? Are other nations exempt from these influences? Why or why not?
7. In what ways does the judiciary make foreign economic policies?
8. Explain how a United States position paper is drafted
9. What role do the reports submitted by United States foreign missions play in the formulation of foreign economic policy?
10. What are the effects of the secrecy classifications of foreign service despatches?
11. Should the Department of State or the Department of Agriculture make agricultural foreign economic policy?
12. Explain the foreign economic policy activities of the NAC and the desk officers of the Department of State
13. Should the Secretary of State be given domestic as well as international responsibilities?
14. What are the limitations on executive branch foreign economic policy determination imposed by the legislative branch?
15. What are the purposes of Treaties of Friendship, Commerce and Navigation?

hensive account of foreign economic policy formulation through the treaty process.

Meade, James. *Trade and Welfare*. London: Oxford University Press, 1955. Chapters 4 and 9 present the fundamental arguments in favor of a free trade policy, chapter 26 gives the "infant industry" and the "economies of scale" tariff arguments. Chapter 32 discusses discriminatory tariff reductions.

Rubenstein, Alvin Z. (Ed.) *The Foreign Policy of the Soviet Union*. New York, Random House, 1960. This is a collection of readings accompanied by extensive notes prepared by the editor. The complex problems of Soviet foreign policy are covered with emphasis on the ideology and objectives of the Communist states.

Steiner, Zara S. *The State Department and the Foreign Service: The Wriston Report—Four Years Later*. Memorandum No. 16, Center of International Studies, Princeton University, Princeton, N. J., 1958. Many of the findings of the Secretary of State's Public Committee on Personnel, the Wriston Committee, were put into operation. This report examines critically the results of the integration of the Washington staff of the Department in the foreign service which the Wriston Committee recommended.

### C. Government publications.

Commission on Foreign Economic Policy. *Report to the President and the Congress*. Washington, D. C.: CPO, 1954. This is the widely-cited Randall Report which covers the post-war dollar problem, foreign aid and investment, United States dependence on imports, agricultural problems, the role played by labor standards and currency convertibility. Representatives Daniel A. Reed and Richard M. Simpson did not agree with this report in all details and submitted a Minority Report (of the Commission on Foreign Economic Policy). Washington, D. C.: CPO, 1954. The studies of the Committee's staff have been published under the title, *Staff Papers Presented to the Commission on Foreign Economic Policy*, Washington, D. C.: CPO, 1954. These papers cover essentially the same fields as the Report itself and provide more detailed information on these topics. *A Critique of the Randall Commission Report*, prepared by Klaus Knorr and Gardner Patterson, International Finance Section and Center of International Studies of Princeton University, 1954, gives an analysis of this Report.

*Report to the President on Foreign Economic Policies*. Washington, D. C.: CPO, 1950. This report, known as the Gordon Gray Report, deals with the significance of foreign economic policy, post-war economic trends and the United States balances of payments, the economic situations in Western Europe, the Sterling Area, Japan and the underdeveloped areas, commodity controls, commercial and financial policy and the foreign assistance programs. It contains recommendations for foreign economic policies to meet post-war and post-Korean problems in the field.

The International Development Advisory Board, *Partners in Progress: A Report to the President*. Washington, D. C.: GPO, 1951. Known generally as the Rockefeller Report, this study deals largely with foreign economic policies related to the problems of underdeveloped areas.

Committees to study foreign economic relations and the foreign aid program were established in the 86th Congress by the Senate Committee on Foreign Relations. A number of reports were prepared for this Committee by outside agencies of which the following two are of particular interest.

The Corporation for Economic and Industrial Research, Inc. *Worldwide and Domestic Problems and their Impact on the Foreign Policy of the United States*. Washington, D. C.: GPO, 1959. This report presents conclusions and recommendations dealing with the Communist threat, policy problems related to underdeveloped areas, the coordination of foreign and domestic policies, common strategy in international economic relations.

Haviland, H. Field, Jr., and Others. *The Formulation and Administration of United States Foreign Policy*. The Brookings Institution, Washington, D. C., 1960. Methods and procedures employed in making and administering foreign economic and political policy are treated. In addition to descriptions of the methods currently employed, the study contains recommendations for the improvement of the procedures used.

All of the studies prepared for Senate Special Committee to Study the Foreign Aid Program, 85th Congress have been published in a single volume, *Foreign Aid Program: Compilation of Studies and Surveys*, Washington, D. C.: United States Government Printing Office, 1957. This compilation includes foreign economic policy surveys for individual countries as well as those on specific aspects of the several federal programs.

*Report to the Committee on Ways and Means on United States Customs, Tariffs, Trade Agreement Laws and Their Administration*. Prepared by the Subcommittee on Customs, Tariffs, and Reciprocal Trade Agreements. Washington, D. C.: GPO, 1957. This is the Boggs Report which contains a discussion of the principal features of tariff laws and the Trade Agreements Program with emphasis on the peril points and escape clause, trade policy and agriculture, the national security amendments, anti-dumping and countervailing duties.

The *Semiannual Reports of the National Advisory Council on International Monetary and Financial Problems*, Washington, D. C.: GPO, give periodic accounts of United States foreign economic policy developments in the fields of money and government credit.

Department of State, *Toward a Stronger Foreign Service*. Washington, D. C.: United States Government Printing Office, 1954. Report of the Secretary of State's Public Committee on Personnel, publication No. 5458. This report gives the findings of the Winston Committee which recommended, among other things, that certain members of the Washington staff of the Department of State be integrated in the foreign service and that the foreign service include more specialists, rather than generalists, in its staffing patterns.

Barnes, William and Morgan, John Heath. *The Foreign Service of the United States*. Department of State. Washington: United States GPO, 1961. This official work presents an account of the origins, development and functions of the foreign service of the United States. It includes an extensive bibliography of the subjects covered.

## Restrictive Foreign Economic Policies: The Protective Tariff

"To provide revenue, to regulate commerce with foreign countries, to encourage the industries of the United States, to protect American labor, and for other purposes. Be it enacted by the Senate and the House of Representatives of the United States of America in Congress assembled,

"Title I Dutiable List. Section I. That on and after the day following the passage of this Act, except as otherwise specially provided for in this Act, there shall be levied, collected and paid upon all articles when imported from any foreign country into the United States or into any of its possessions (except the Virgin Islands, American Samoa, Wake Island, Midway Island, Kingman Reef, and the Island of Guam) the rates of duty which are prescribed by the schedules and paragraphs of the dutiable list of this title, namely . . ."

Thus read the opening paragraphs of the Tariff Act of 1930, the last one enacted. In paragraphs 1 to 1558 of the Dutiable List of this Act, there are enumerated several thousand articles subject to that special and old form of excise tax, the customs tariff.

The word "tariff" comes through the old French word, *tarife*, which meant a rate, price or a list of rates and prices, from the Arabic, *ta'rif*, meaning notification, which, in turn, was derived from *'arafa*, to know. According to usage in the United States, the word has three meanings. It may refer to a list of articles together with the rates of duty which must be paid when they are imported, to the actual amount of duty levied, or to the law establishing such a schedule. A synonym for tariff is the term "customs duties," used because these duties are customary and have been collected over a long period of time.

Taxes upon goods exchanged or transported are nearly as old as trade itself. Today's customs duties originated in the transit taxes levied

by king, lord, bishop or other authority on products passing through a district under their jurisdiction. These taxes raised funds to pay for the maintenance of roads, bridges or waterways; to recompense the tax authority for the protection accorded the merchant and his goods and for the right of using the facilities as well as for the purpose of adding to the revenues of the ruler of the district. The modern toll road and bridge constitute a revival of these old transit taxes.

Although tariffs on the import of goods were known in Rome and other parts of the ancient world, their systematic development as a cornerstone of foreign economic policy dates from about 1500, the period of the ascendancy of the Mercantilists.

Under the influence of the British practice of the day, the early American colonies levied customs duties both to protect home industry and to reduce the consumption of products which were deemed harmful. These duties aroused popular resentment and had one important effect: The federal Constitution, in Article I, Section 8, Paragraph 3, forbids the levying of import and export duties by the several states. In addition, the federal government, under Article I, Section 9, Paragraph 5, may not levy export duties.

### Types and Features of Customs Tariffs

*Revenue and protective tariffs.* It is common to distinguish between tariffs for revenue and for protection, although the difference between them is theoretical. There are few protective tariffs which do not yield some revenue and few revenue tariffs which do not afford a modicum of protection. The names of these tariffs are self-explanatory, a *protective tariff* is one designed to protect home industry, agriculture and labor against foreign competition, a *revenue tariff* is one designed primarily to provide revenues for the government.

A theoretically perfect protective tariff has rates so high that the import of the protected commodities is prohibited. The protective tariff is designed to raise the effective prices of imported goods so as to render them less competitive with domestically-made products. Thus, if the American jewelled watch industry is suffering from the competition of Swiss watches, a tariff can be levied on watches which will raise the prices of the imported articles. Domestic watches can then be sold at prices lower than the Swiss and thereby prove more attractive to consumers. Or the higher prices of Swiss watches might enable American watchmakers to raise their prices up to, or just below, those of the tariff-taxed Swiss products.

A good revenue tariff should be levied at relatively low rates upon products which are imported in large quantities and which do not com-

pete with domestically-produced commodities. It can best be placed on goods for which there is an inelastic and stable demand, and duties should not be so high that they will discourage consumption, or encourage smuggling. If the revenue tariff is levied on products which are also made at home, the protective feature can be eliminated by placing an equal excise tax upon the domestic products. In the nineteenth century, when Britain was using a revenue tariff, duties were levied principally upon tobacco, tea, sugar, and alcoholic beverages; only alcoholic beverages were domestically produced.

*Revenue and protection in United States tariffs.* The first American tariff, that of 1789, placed duties on sugar, cocoa, tea, coffee, and alcoholic spirits, among other commodities and, despite its declared intention of being a protective tariff, it was almost a pure revenue measure. Until the Civil War about 90 per cent of all the revenues of the federal government were obtained from the tariff. Thereafter, until World War I, about one-half of federal revenues were derived from this source. Ever since, the tariff has declined in relative importance as a source of federal funds, and now it provides but slightly more than 1 per cent of these revenues. Much of the decrease has been counterbalanced by the increase in yields of the federal income tax, both individual and corporate. The present American tariff, that is, the Tariff of 1930 as changed by the negotiations under the several Trade Agreements, is a mixture of both protective and revenue features.

*Possible failure of the protective tariff to protect.* The protective tariff is an outmoded method of protecting industry against foreign competition. A tariff may be protective when enacted, but foreign competitors are often able to reduce their costs, improve their products and thus neutralize its effects. To continue to be effective as a protective measure, the tariff must be altered to meet developments in technology and to keep it abreast of industrial progress. The systems of import and exchange controls so widely utilized for balance of payments purposes during and after World War II, are the modern methods of protecting industry against foreign competition. These devices, more fully discussed in the next chapter, make it possible for a government to pinpoint its protection. By refusing to issue an import license or grant foreign exchange, a government can absolutely prevent the entry of foreign goods, regardless of any changes in products or industrial technology.

*Specific duties.* From the point of view of types of duties imposed under a tariff, there are three kinds of rate structures: *specific*, *ad valorem*, and *combined rates*. Specific rates impose a duty of so many dollars or cents for a given unit of measure, as one dollar per ton, ten

cents per square yard, five cents per linear foot, two dollars per gallon. Thus the duty on orange mineral-lead pigment is two cents per pound (paragraph 70); on baby chicks, two cents each (paragraph 711), concentrated juice of citrus fruits, twenty cents per gallon (paragraph 806). The tariff on watch movements (paragraph 367) is a complicated type of specific duty providing for duties according to the size of the movements, the number of jewels and adjustments, among other things.<sup>1</sup>

The specific duty rates on watch movements afford a good illustration of the impact of progressing technology upon the customs tariff. Duties are levied on each adjustment made to a watch movement. Under modern watchmaking methods, some adjustments are no longer applied to a watch movement, but are now *built into it* by the design and the type of materials used. The adjustment for isochronism, for example, is determined by the shape of the hairspring; the adjustments for temperature, by the design and materials used in the balance wheel and hairspring. A customs appraiser cannot determine whether or not an adjustment has been made to a movement, because there is no test which can be applied to make such a determination. The result is that many Swiss watches are classed as "unadjusted," when they are so well designed and constructed that adjustments are not needed.

*Ad valorem duties* Ad valorem duties are applied as a percentage of the value of the imported goods. On hose and half hose, for instance, the duty is 15 per cent of their value (paragraph 916), on motorcycles, 10 per cent (paragraph 369). The determination of duties under the ad valorem principle appears to be relatively simple, but in practice it has often proved difficult to administer fairly and correctly. The value of an imported article is "appraised," or determined, by a customs appraiser. There is often more than one value which might be applied to a given article and value frequently changes in both time and space. Some items with particular characteristics offer difficult evaluation problems and duties based upon value have given rise to much litigation.

Before the passage of the Customs Simplification Acts, the appraiser applied the foreign value or the export value, whichever was the higher. If neither of these were ascertainable, the appraiser applied the United States value, and if this could not be determined the duty was levied on the basis of cost of production. As a general proposition,

<sup>1</sup> The tariff paragraph references (in parentheses) in this chapter are to those of the Tariff Act of 1930, as amended by subsequent legislation and altered by the several Trade Agreements which the United States has signed. Since Trade Agreements are frequently negotiated, the rates of duty cited are subject to change.

the Export Simplification Act of 1956 provides for the use of export value except in certain cases where the import duty collected would be decreased by more than 5 per cent. In these cases, either export or foreign value may be used as a basis of customs valuation. About 16 per cent of all ad valorem imports is collected under the dual valuation system—foreign and export value—and 84 per cent under export value alone. Valuation, even under this simplified procedure, still involves many questions of fact and judgment and continues to give rise to difficulties.

The determination of value also involves the use of a rate of exchange unless the merchandise is billed in United States dollars. The Bureau of the Customs uses the rates furnished by the Federal Reserve Bank of New York or the Secretary of the Treasury. These rates may differ from those actually used by the importer when he purchased the merchandise.

Another problem involved is that of determining the proper classification of the imported commodities. The classification process is a means of deciding under what tariff paragraph a commodity will be taxed. Since there are wide differences in the applicable rates among the several paragraphs, classification becomes a matter of prime importance to all importers. Thus bleached beeswax (paragraph 1556) pays a duty of 15 per cent, while vegetable wax is on the free list (paragraph 1796) and pays no duty at all. It is, therefore, important that imported wax be properly classified for duty purposes. Classification has also given rise to much dispute and litigation and, according to some importers, has at times been capriciously determined in an effort to collect the maximum duty and to render the tariff as protective as possible.

*Price movements and protection* Under the ad valorem duties, the duties paid vary with the price of the article and are proportional on both low- and high-price products of the same class. If the duty on an item is 25 per cent ad valorem and its price \$10.00, the duty amounts to \$2.50. If the price of the article increases, say to \$12.00, the duty collected amounts to \$3.00 whereas if the price falls to \$8.00, the duty drops to \$2.00. This type of tariff tends to yield revenues proportionate to price movements and to continue its degree of relative protection at all price levels.

Specific duties, on the other hand, remain constant regardless of relative value and price movements. The total specific duty on a certain type of watch movement, of say \$2.50 per movement, remains the same no matter what the price may be and percentage-wise is relatively heavier on low priced than on higher priced movements. If this

watch movement were priced at \$10.00, the duty would be \$2.50, the same as on a similar type of movement priced at \$100.00. Such a tariff has a *regressive effect*, resting more heavily on low than on high incomes.

The specific rate has, in addition, a certain perverse elasticity. As prices go up the percentage of the duty declines; as prices fall, the percentage increases. Thus, during a business cycle downswing when prices are declining, the specific duty remains the same and the percentage rate of the tax rises, as prices rise during a cyclical upswing, the duty rate constitutes a relatively lower tax, percentage-wise. Taxes should fall during a cyclical downswing and rise in the upswing, but specific duties behave in the opposite manner. The specific duty tends to become less protective during periods of rising prices and more protective when they fall.

*The combined duty rate.* The fact that specific duty rates do not yield revenues in proportion to price movements has led to the creation of *combined rates*—duties which place both a specific and an ad valorem rate on the imported commodity. The duty on cotton shirt collars and cuffs (paragraph 919) is fixed at fifteen cents per dozen pairs plus 5 per cent ad valorem and represents a combined rate. Although combined rates do not provide revenues which follow the movement in price as well as ad valorem rates, they are better in this regard than specific duties and represent a compromise between these two types. The larger the share of the ad valorem duties in the combined rate, the closer the correspondence of revenue yields to movements in price.

*Maximum and minimum rate limits.* Sometimes a floor is placed under or a ceiling over the tariff rates, specific, ad valorem and combined, to guarantee a minimum rate or to prevent the collection of duties in excess of certain amounts or percentages. Thus, some types of steel bars (paragraph 304) carry a duty of 10 per cent but not under 7/8 of a cent per pound and specified boiler plates (paragraph 307) pay 10 per cent ad valorem, but not over 0.175 cents a pound. The United States tariff structure provides for a number of these rates, which are sometimes called *not over and not under duties*.

*Ad valorem equivalents.* The ad valorem type of customs duties presents one important advantage for the foreign trade analyst. It shows the tariff as a percentage of the value of the import, permits the comparison of the burden of customs duties on different types of products, and gives a clear picture of the relative importance of the tariff on the various commodities on the dutiable list. Specific duties cannot be so easily compared. A duty rate of one-fourth of a cent per pound on flax noils (paragraph 1001) is not comparable with that of \$1.50 per

proof gallon levied on imported whiskeys (paragraph 802). A similar difficulty arises with attempts to compare the relative burden of the duties on commodities where combined rates apply.

To facilitate these comparisons, foreign trade analysts compute the *ad valorem equivalents* of the specific and combined rates which express the specific duties collected in terms of percentages of the value of a unit of an imported commodity. To compute *ad valorem equivalents* the total volume and value of the imports of a commodity for a given period must be known as well as either the total duties collected or the applicable tariff rates. The total imports by both quantity and value and the total duty collected are given in the publication of the Bureau of the Census, *Foreign Commerce and Navigation of the United States*, and the *ad valorem equivalents* of both the specific and combined duties can be computed from these data.

If 100,000 units of a given commodity having a total value of \$100,000 were imported and \$10,000 in duties were collected on it, the unit value of the commodity is then \$1.00 and the rate of duty, whether specific or combined, amounts to 10 per cent. Since the *Foreign Commerce and Navigation of the United States* appears several years late, the Bureau of the Census publication, *Report No. FT 110*, giving United States imports, commodity by country of source, may be used if more up-to-date data are required.

This *Report* does not show the total duty collected, but gives the value and the quantity of each item imported. Take the case of a product carrying a combined duty of 10 cents a piece plus 10 per cent *ad valorem*. The total quantity imported is, say, 100,000, and its value \$100,000. Since the specific part of the combined rate is 10 cents per piece, the *ad valorem equivalent* in this case is 10 per cent of the value of the product. This percentage, when added to the *ad valorem* rate of 10 per cent, gives a total *ad valorem equivalent* of 20 per cent.

When the duty rates carry not over or not under provisions care must be used in computing these equivalents because they cannot exceed or fall below these limits, as the case may be. If, in the case cited in the previous paragraph, the rate provided for duties not over 18 per cent, the *ad valorem equivalent* was 18 per cent. If the rate provided for duties not under 22 per cent, the equivalent was 22 per cent.

The tariff duties applicable to any commodity can be obtained from a number of sources. The Tariff Commission publishes periodically *United States Import Tariff Duties* which is arranged by tariff paragraph number. The *Customs House Guide*, published annually by the Customs House Guide of New York, presents the duty rates in several conveniently arranged classifications. In addition to the tariff para-

graph number, the *Customs House Guide* carries the Schedule A number, which identifies each commodity and is used in machine tabulation of United States import statistics. Since import statistics of the United States generally include the identifying Schedule A number, the applicable tariff duties can be ascertained by cross-reference, using both the Schedule A number and the applicable tariff paragraph.<sup>2</sup> In the use of all tariff duty rates, care must be taken to make certain that the listed rates are current, for under the Trade Agreements Acts these duties may change from negotiation to negotiation.<sup>3</sup>

*Single-column and multi-column tariffs.* When a nation gives equal tariff treatment to all countries it is said to have a *single-column* or *unilinear* tariff because the same rates of duty apply to the imports from all countries. Except for minor deviations, the United States has a single-column tariff. Argentina, Japan, the Netherlands, Switzerland and the Scandinavian countries also use this type.

Multi-column tariffs take several forms but, as the name implies, in all of them the tariff schedule has more than one column, the rates in each column apply only to certain countries. The *general conventional* tariff has one column of duties applicable to all countries with the exception of those with which trade or tariff conventions entitling them to lower rates have been signed. Australia, Chile, Czechoslovakia, Finland, New Zealand and Turkey use this type. Another form of the multi-column tariff is the *minimum-maximum* rate type, a two-column schedule with the minimum rates applying to countries which have signed trade treaties or agreements entitling them to most-favored-nation treatment. Other countries must pay the rates in the maximum column. Brazil, France, Greece, and Poland are the principal countries which employ this type.

*Preference or preferential tariffs* are two or more column duty schedules with a set of preference rates applying to certain countries and different rates applying to others. The British Imperial Preference Tariff, with one column of rates paid by members of the British Commonwealth and another, and higher, paid by other countries is an example of this type. *Customs unions, free trade areas and common mar-*

<sup>2</sup> The United States Tariff Commission computes the ad valorem equivalents of both specific and combined rates which may be obtained from the Commission on request.

<sup>3</sup> The ad valorem equivalents computed according to these formulas apply only to the period covered by the data and may change over time as the prices of the imported goods vary. If a tariff is prohibitive and prevents the import of some items, a theoretical ad valorem equivalent can be computed by estimating the prices and measures of the proposed import and expressing the total duty applicable in terms of a percentage of its value.

*kets* provide one schedule of tariff duties for members of the organization and another for those countries outside of the organization. This type is employed by the Benelux Customs Union, the European Economic Community or Common Market and the European Free Trade Association.

*Other tariff characteristics.* A *drawback* is a customs duty which is refunded to the importer when imported tariff-taxed commodities are re-exported either in their original form, after they have been processed or incorporated in some manufactured product. Where domestic manufacturers must pay a higher price for their raw material than foreign competitors because of domestic price-support programs, *compensatory duties* may be applied to the imports of certain competitive manufactured goods to equalize the respective costs of production. Where a nation desires to encourage the export of certain goods, or where domestic costs of production are higher than those which prevail abroad because of price-support programs, *subsidies* are often paid exporters to encourage their sales abroad by rendering their exports more competitive on foreign markets.

*Countervailing duties* may be imposed on certain imports when they have been subsidized by foreign governments. Thus when the Secretary of the United States Treasury found that Spain was maintaining a multiple exchange rate system and was applying undervalued rates of exchange to the export of filberts (hazel-nuts) he applied countervailing duties, in addition to the normal rate of duty, to counteract the subsidy effect of the undervalued rate. *Anti-dumping duties* are applied to imports when it is found that they are being dumped on domestic markets at prices either below their cost of production or substantially lower than their domestic levels. Countervailing and anti-dumping duties are in the nature of an addition to the regular rates and are a form of *penalty duty*.

Customs tariff duties of the United States are applied to imports when they enter a geographic area defined as the *Customs Territory of the United States*. Generally speaking, the customs territory includes the area covered by the United States and its possessions including the marginal waters to the three-mile limit on the seaboard and to the boundary lines on the north and south. Since Puerto Rico is defined as lying within the United States customs territory, imports into this island pay its customs duties but imports into other parts of the customs territory from Puerto Rico pay no duties, an arrangement which has important advantages for the agriculture and industry of that island.

Imports which enter the customs territory of the United States and which are stored in *bonded warehouses* are not subject to duties until

they are withdrawn. This arrangement enables importers to bring in merchandise without immediately paying the duty on it and to obtain the advantages of quantity buying. In addition, importers can maintain stocks of imported goods in bonded warehouses for rapid delivery to customers without paying the duty until the goods have been withdrawn. Commodities imported into the United States *in transit* to a foreign country are exempt from our customs tariff duties.

*Free ports and Foreign Trade Zones.* During the Middle Ages, *free ports*, some of which still exist, were established in various countries of Europe for the convenience of foreign traders. Goods could enter these ports without paying any duty; it was only paid when the goods were shipped into the customs territory of the country in which the port was located. Foreign traders use the free ports as entrepot centers to store and assemble merchandise before shipping it elsewhere. Goods in these free ports can be placed on display, cleaned, mixed and used in the manufacture of other products.

The free port idea was not accepted by the United States until 1934 when the Foreign Trade Zones Board was created by an Act of Congress. This Board administers *Foreign Trade Zones* which resemble in some respects the free ports of Europe. These Zones are operated as public utilities and are held to be outside the customs territory of the United States. Goods can be imported into them without paying any duty, but tariffs must be liquidated when the goods are brought into the territory from these Zones. The principal Zone is located in New York, and others are situated in other ports. While in these Zones, importers may exhibit, clean, package, repackage, process goods from abroad and incorporate them into manufactured products. Many of the goods brought into them do not enter the United States but are re-exported to other destinations.

### Protectionism Versus Free Trade

Protectionism refers to the use of the tariff and other import-reducing devices to protect domestic industry, agriculture and labor against foreign competition, and free trade means that no, or but few, legal barriers are erected against the entry of foreign goods on the domestic market. The terms are relative, few countries have used complete protectionism whereby the entry of all foreign goods is restrained, and few have had complete free trade with no legal barriers whatever against the importation of foreign goods. Until 1934, with the passage of the Hull Reciprocal Trade Agreements Act, discussed in chapter 22, the history of the United States had been on the whole one of increasing protectionism.

*Historical sketch of the United States tariff.* Protectionism in the United<sup>1</sup> States received its initial impetus in 1791 when Alexander Hamilton submitted to the House of Representatives his *Report on Manufactures*. Hamilton believed that as long as the United States confined its protection to agricultural products and raw materials, its prosperity would depend upon the uncertainties of foreign commerce. Therefore, he advocated the encouragement, through light tariff protection, of domestic manufactures.

Between 1789 and 1812, the United States passed thirteen tariff laws mainly for revenue and increased some of the tariff rates during this period. After the conclusion of the War of 1812, the growing demand for protection against foreign competition led to the Tariff Act of 1816, which included increased rates on several articles. Some of these were again raised in the Tariff Act of 1824 as well as in the so-called Tariff of Abominations of 1828.

The Tariff Act of 1832 lowered the rates on some imports. It was followed by the Compromise Tariff of 1833, which planned a reduction of the rates over a one-year period to bring the maximum on any article down to 20 per cent. In 1846, the Walker Tariff again lowered the rates and the Tariff Act of 1857 reduced them still further.

With the Civil War, which required higher revenues, the federal government initiated a series of legislative acts which steadily increased duties. The most important tariffs of the Civil War period were those of 1861, 1862 and 1864, all of which raised the rates. At the close of the War, a strong demand for continued protection resulted, in 1867, in an increased tariff on woolen goods, and the Act of 1870 added protection to other items. After the panic of 1873, when tariff reduction became a leading issue in the political campaigns of both 1876 and 1880, the Act of 1883 lowered duties slightly. However, the McKinley Tariff of 1890 again raised the rates.

In 1893 the Wilson Tariff reduced the tariff somewhat, but in 1896 the Dingley Tariff again instituted increases in duties including those on wool and on some textiles. The Dingley Act was followed by the Payne-Aldrich Tariff of 1909, which lowered some rates and established minimum and maximum duties, to be established by the President. This Act also provided for the use of countervailing duties on foreign articles produced with the aid of foreign government subsidies.

The Underwood Tariff of 1913 reduced duties, substituted *ad valorem* for specific rates on many commodities, made some additions to the free list, and taxed luxuries at higher rates than necessities. An Emergency Tariff was passed in 1921 providing for increased protection, especially for agricultural commodities, and in 1922 the Fordney

McCumber Tariff Act raised the duties to higher levels than those which had prevailed for many years in the past.

In 1930 this Act was superseded by the Hawley-Smoot Tariff, called the most restrictive in American history. Some of the increases in rates were planned to be prohibitive. The number of dutiable items was raised from 2840 in the Act of 1922 to 3321. Furthermore, the decline in prices after 1929 helped make the specific duties of this Act more protective than they otherwise would have been.

*The United States Tariff Commission.* In 1916 the United States Tariff Commission was created as an independent, fact-finding body authorized to study, make reports and recommendations on the tariff in the belief that it would help to make it less a political issue than it had sometimes been in the past. The Tariff Commission consists of a body of six members—three Democrats and three Republicans—appointed for terms of six years by the President with the approval of the Senate. The Commission, which employs a staff, is permitted to examine the files of any business concern, to order witnesses to testify, and to bring documentary evidence with them.

One of the important duties of the Tariff Commission stems from the flexible provisions of the Tariff Acts of 1922 and 1930 which gave the President power to raise or lower duties by a maximum of 50 per cent whenever the Commission found that they did not equalize foreign and domestic costs of production. The Commission was authorized to make studies of production costs at home and abroad, to make recommendations to the President concerning appropriate rates of duty, and to conduct cost-of-production studies in various parts of the world. Since the inauguration of the Reciprocal Trade Agreements Program in 1934, the work of the Tariff Commission has been enlarged. It is responsible for the determination of the peril points under this program, for holding hearings, and for making investigations and recommendations under the escape clause provision of these Agreements. In addition, the Commission does much of the spade work involved in the preparations for Trade Agreement negotiations, participates in them, and follows closely their execution. It is the principal source of information on all tariff matters, both domestic and foreign, and publishes a large amount of source material on the subject.

*The protectionist-free trade debate.* During the nineteenth century the tariff was a leading issue in national political campaigns. In general, the Republicans leaned toward protectionism while the Democrats tended to favor freer trade. Free trade vs. protectionism was a favorite topic for political and school debates, and one might think that by now the subject has been adequately covered. However, the tariff issue is

still an important one even though it no longer occupies the center of the political stage.

*Keeping the money at home* is one of the older of the protectionist arguments and is not often heard today. Under foreign trade, the argument runs, some money will leave the country and fall into the hands of foreigners who become wealthier, and we consequently poorer. Partisans of freer trade point out that this argument embodies the old Mercantilist fallacy of regarding money, instead of goods, as wealth.

*Increasing the number of jobs* is also an outmoded argument. On the surface, it appears plausible, for the purchase of more American goods should mean more work for Americans. Opponents of protectionism reply by pointing out that if the United States reduces its imports, foreigners will earn fewer dollars and buy fewer American exports. Since a loss of exports also entails a loss of jobs, a decline in imports could mean, on balance, no increase in jobs for Americans.

The idea has also been advanced that the United States needs a tariff to *equalize the costs of production* between foreign and American industry. The Tariff Commission, under direction from Congress, has made studies of comparative foreign and American costs of production. Since costs vary greatly among foreign producers even in the same country, some economists contend it is impossible to determine just what costs need to be equalized. Moreover, they maintain, trade takes place in part because of cost and price differentials, if all costs were equalized, there might be considerably less foreign trade.

The well-known *infant industry* argument, which stresses the need of a tariff to promote industrialization, is regarded by many as the strongest point favoring protectionism. The philosophical support for this doctrine came from the pen of Friedrich List.<sup>4</sup> Free traders point out that while this argument might apply to some underdeveloped areas, the United States is the industrial giant of the world and has relatively few infant industries. The principal difficulty with this argument, some foreign trade analysts indicate, is that once an industry obtains protection, it grows up behind the tariff wall and cannot afford to see the tariff lowered, it gets a vested interest in protection and cannot live without it.

The statement that American labor must be protected from *cheap foreign labor* is still often heard. Wages are higher in the United States than in any foreign nation, and often the difference between United States wage rates and those of other countries is large. Because the fringe and social security benefits paid foreign labor are often higher

<sup>4</sup> List, Friedrich. *The National System of Political Economy*. New York, Longmans, Green and Co. 1904.

than in the United States, the comparison of wage rates alone does not tell the whole story. However, economic theorists declare, it is neither the wage rate nor the fringe benefits which determine the cost of the product. Many American industries paying wages several times as high as those which prevail abroad have lower unit costs of production. If some industries in the United States are unable to pay the going rate of wages and continue to compete with foreign industry, it is because wages have been bid up by other and more efficient American industries. The opponents of American protectionism contend that, if any particular industry cannot pay these going wages, there is little reason why the American people should continue to support it.

An old argument, *self-sufficiency*, is now termed *national security*. This argument maintains that this nation should become self-sufficient, because in time of war it might be shut off from sources of supply by a blockade, or productive capacity in certain industries might have been permitted to decline to a point inconsistent with national safety. In reply, it may be argued that many industries find it necessary to import their raw materials and could never become entirely self-sufficient with or without a tariff. This same argument contends that if a complete blockade could be maintained against any country, that country would probably lose a protracted conflict and the notion that any nation can become completely self-sufficient and cease to rely upon foreign sources of supply does not correspond to the facts of modern industry and international trade.

The case for freer trade rests upon the principle of comparative costs, discussed in chapter 15. Under this principle, the most efficient use of a nation's resources is obtained when they are employed in those activities for which it has the greatest comparative advantage. In any other use, fewer products and lower national incomes prevail.

*The transition from protectionism to freer trade.* Since 1934 the United States has been following the road of freer trade. Under the Reciprocal Trade Agreements Program, described in chapter 22, protectionism has been slowly abandoned and the tariff has been lowered on over 3,000 separate items. If present tendencies continue, additional tariff reductions will doubtless be forthcoming in the years ahead.

*Other competition-reducing foreign economic policies.* The customs tariff is not the only obstacle which the United States importer and the foreign exporter to this country encounter. Much legislation has been passed under the police powers of the federal government to protect the health, morals and welfare of the American people. These acts are not primarily directed against imports and they apply to goods of domestic as well as foreign origin. This legislation has not

always been well understood or followed by foreign producers and exporters. Consequently, the offending shipments of goods have necessarily been returned to their country of origin, quarantined, seized or destroyed. These regulations have from time to time occasioned dissatisfaction abroad and have sometimes been misinterpreted as another facet of American protectionism.

Other measures which serve to restrict foreign trade are discussed in the next chapter. These are quantitative, export, exchange and other controls, which are often employed for balance of payments reasons but may also have protective effects. The nature and uses of cartels and bilateralism, which also serve to restrict trade, are examined

### QUESTIONS AND PROBLEMS

- 1 Write a note on the origin of customs tariffs
- 2 Describe or define tariff for revenue, tariff for protection, countervailing duties, anti-dumping duties, single-column tariff, multi-column tariff, specific duties, ad valorem duties, Foreign Trade Zones, Customs Territory of the United States
- 3 Define or describe combined tariff rates, compensatory duties, preference tariffs, drawbacks, bonded warehouse, evaluation of goods for tariff purposes, classification of goods for tariff purposes, minimum-maximum rates
- 4 What inferences do you draw from the history of the United States tariff?
- 5 Sketch some of the problems associated with ad valorem tariff rates
- 6 Explain some of the problems associated with specific duty rates
- 7 How would you compute the ad valorem equivalents of specific and combined tariff rates?
- 8 Discuss the principal arguments in favor of tariff protection
- 9 Discuss the principal arguments in favor of freer trade
- 10 Explain the reasons for the generally increasing trend of tariffs in the United States between 1789 and 1930

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## Restrictive Foreign Economic Policies: Other Controls, State Trading, Bilateralism and Cartels

"In the immediate post-war period, quantitative restrictions were so widespread that for some time customs tariffs were of secondary importance. The extensive use of such restrictions by practically all countries was self-defeating. Every country's imports are another country's exports; import restrictions only served to aggravate the contraction of trade and spread it over all countries. The innumerable bilateral agreements regulating international trade were similar to primitive forms of barter. Since bilateral trade must balance within narrow limits and over rather short periods, the result was a severe limitation of trade and a serious threat to the rational division of labour between countries."

This succinct statement of the results of trade controls appears in the Tenth Annual Report of the Organization for European Economic Cooperation, *A Decade of Co-operation*, (1953). Although these controls may have been dictated by necessity, their restrictive character was well known and they tended, in some respects, to replace the tariff as trade protection devices. The principal types of these barriers are quantitative controls, trade and exchange licensing, state trading, bilateralism, cartels and monopolies.

### Quantitative Controls

Quantitative controls generally involve the establishment of quotas to limit the amount of goods imported or exported by a nation. They were not widely employed before the 1930's. The tariff was the preferred method of restricting trade, but by the thirties, some of the weaknesses of the tariff as a protective device were recognized. Depression-ridden economies and the growth of nationalism prompted some nations

to seek more effective controls over foreign trade. Quantitative controls consist of export quotas which limit the amount of merchandise which may be exported and import quotas which limit the amount which may be imported. Of the two, import quotas are the most frequently employed.

**Export quotas.** These controls are used to protect a nation's supply of commodities which are produced in insufficient quantities for domestic purposes, or for short supply reasons; to divert goods away from soft to hard currency areas and thereby permit greater exchange earnings of the latter type; for strategic or political reasons. During and after World War II several countries used export quotas at the instance of the International Emergency Food Council to protect commodities in short supply and to insure their export to those areas where they would prove most useful. India utilized such quotas to direct the export of raw hides and sheepskins to countries which could pay in hard currencies. The United States used this means both during and after the second World War to protect goods in short supply; to insure that they would be sent where the need was the greatest; and to reduce the risk of their falling into the hands of the enemy.

Export quotas are determined either globally or nationally for each importing country and they can be established in a variety of ways. One widely employed method is to establish a nation's quota as a certain percentage of its imports from the controlling country during some historical base period. Quotas are also established as the result of political considerations or by negotiation and agreement.

The administration of these systems generally requires some form of export licensing, unless the goods are exported by the government, to insure that each importing country gets its allocation and that each exporter gets his share of the limited export possibilities. The export quota may be allocated among the several exporters on several bases; usually the quota is assigned on a percentage basis. Each exporter's percentage is based on his sales, or exports during some preceding base period. Usually a small quota is set aside to provide for newcomers in the field who would have no quota if it were computed entirely on the basis of historical records.

**Import and import tariff quotas** There are two types of import quotas: the *import tariff quota* and the *import quota*. Under the import tariff quota, the imports of a given commodity, up to the amount of the quota, pay one rate of duty, usually that prescribed in the tariff schedules. Imports in excess of this quota pay an additional and higher rate of duty. The import quota, on the other hand, places a definite ceiling on the amount of goods which may be imported during the specific period. Under the import quota, the duty on all imports is the

same; a limit is placed on the volume of the commodity which may be brought in during the quota period.

The United States has used the import tariff quota system in conjunction with its several Agricultural Adjustment Acts. Since these Acts are designed to limit production, to raise farm prices and income, the amounts of the commodities imported should be limited; otherwise the administration of the law would become difficult and expensive. Although import tariff quotas may be an essential ingredient of the United States Agricultural Adjustment Programs, their use has provoked resentment abroad, has hampered this country in its efforts to obtain relaxation of the trade barriers raised by other countries as well as in its advocacy of relatively free, multilateral trade. The United States has placed import tariff quotas on whole milk and cream, certain types of cheese, butter, shelled walnuts, potatoes, cattle, and fish fillets, among others.

Import quotas were probably first used by France in 1931, as a counter-depression measure. By 1934, that country had established quotas for some 3,000 imported items. The intent of these French quotas was at first for protection, but they were retained to conserve short foreign exchange reserves. Import quotas are a more restrictive measure than the tariff, because they regulate with some precision the extent of the competition to which domestic industry is subjected. They allow a nation to select sources of supply and are useful as trade bargaining weapons. Import quotas were widely employed by European nations during the post-war years, primarily for balance of payments purposes.

Like import tariff quotas, they have been used by the United States in conjunction with the several Agricultural Adjustment Acts. Under the Act of 1948, the President was granted the authority, upon the recommendation of the Tariff Commission, to impose quantitative limitations upon specified imports if they interfered with or rendered ineffective, the agricultural price-support program. The United States has imposed import quotas on such items as wheat, wheat flour, cotton and sugar.

During the depression of the thirties, import quotas were employed principally as protective devices against trade in agricultural products. In the post-World War II period, balance of payments and exchange reserves considerations prompted their adoption. Although foreign exchange shortages may have constituted a valid motive for their use, foreign trade was nonetheless restricted. Accordingly, many nations, especially the United States, took steps after the second World War to eliminate or reduce these import quotas.

The Organization for European Economic Cooperation (OEEC) and the European Payments Union (EPU) also opposed them. The EPU Agreements, in addition to arranging for currency settlements and clearing, also envisaged the reduction of barriers to trade. An early OEEC Agreement provided for the gradual reduction of trade barriers and each member was required to abolish quantitative restrictions on 60 per cent of its private imports from other members. This percentage was later increased and by 1961, quantitative restrictions remained on relatively few commodities. The European Economic Community, or Common Market, also plans the elimination of these restrictions, and they no longer appear to be a serious threat to world trade.

### Trade and Exchange Controls

The distinctions between quantitative restrictions and controls over trade are technical. Both serve similar purposes, the differences among them are those of method.

*Import controls* In the administration of quantitative restrictions on imports, some form of licensing, as indicated in a previous paragraph, is employed both for import tariff and import quotas. Under another form of import licensing, *import controls*, the overseas purchases of a country are usually divided into groups: one group consists of articles which may be brought in freely, the other includes those which a government desires to control.

Where products are controlled, a permit or license must be obtained for each importation. This system allows a government to regulate the total amount of the goods brought in, to select their source, to determine the firms which are allowed to import, and the specifications and qualities of each item imported. They can be employed for political as well as economic goals in favoring some countries and exporters and discriminating against others.

A number of administrative problems arise in connection with their use. Unless the system is to be arbitrary, some basis for the allocation of the total amount programmed for import must be determined. Often the historical method is utilized, with quotas assigned each source country and each importer based upon the transactions during some past period. A certain amount is usually set aside and assigned to newcomers in the field who otherwise, since they have no base, might be unable to import the goods at all. Their administration is thus similar to those of quantitative controls.

Import controls have been employed in the past on many occasions. They were widely used by belligerents in World War II to con-

serve scarce foreign exchange for the war effort and to select sources of supply and control the distribution of certain goods. For instance, if the United Kingdom needed a commodity available in both Spain and Portugal, but was shorter of Spanish pesetas than of Portuguese escudos, import licenses might be issued for the importation of the product from Portugal rather than from Spain. In conjunction with the use of the priority systems which regulated the distribution of strategic and scarce raw materials, import licenses were granted to those firms which had high raw material priorities and refused to those with lower ratings. It is, of course, ineffective to ration the domestic production of materials without, at the same time, controlling their importation. Shortages of imported goods continued to plague many nations after the war, and consequently some of these controls were retained after the cessation of hostilities.

**Export controls.** During the second World War, export controls formed an essential feature of programs of economic warfare where they were employed as an integral part of the blockade. They were also used in conjunction with Allied programs for the treatment of neutrals as means of allocating them a share of the products in short supply.

Even before the United States entered the war, it participated in the blockade by installing a system of controls over exports. On July 2, 1940, the Office of the Administrator of Export Control was established and charged with the function of determining what exports should be made and their permissible destinations. These controls enabled the United States to lessen the drain on scarce items to prevent American goods from reaching the Axis, to reserve for domestic use those products essential for national defense, and to provide an orderly method for neutrals to obtain materials essential to their economies.

Under United States export controls, exportable goods were divided into two groups: those goods which could be exported freely and those which were controlled, i.e. placed on the Positive List and requiring an export license before being shipped abroad. By 1944 some 3,000 items were on the Positive List, on VJ Day approximately 800 remained on it; at the end of 1947 about 350 articles were still under export license. Since then the Positive List has been changed from time to time as circumstances have required and at the end of 1960 it contained 945 separate entries.

During the second World War, export controls were reinforced by a blacklisting procedure. Importers and consignees abroad, suspected of transshipping controlled items to unauthorized destinations or of trading with the enemy, were placed upon a schedule called "The Proclaimed List of Certain Blocked Nationals" (blacklist) and exports to

these persons and firms were prohibited. This procedure rendered export control more effective, but in spite of all precautions some goods managed to leak through to unauthorized destinations.

Items on the Positive List were controlled by a licensing procedure. Licenses were issued to exporters to the Allies for such items and quantities as these nations could justify and which could be spared from United States requirements. Most of the Allies had some form of export control. These procedures proved to be an effective blockade measure and a means of assuring that limited war-time supplies were utilized most effectively.

The export licensing procedure was also used to supply friendly, non-belligerent neutrals with commodities essential to the maintenance of order and stability and to assure their continued neutrality. These countries furnished the United States with lists of requirements which were screened and an approved schedule was drawn up. Only goods on this schedule were licensed for shipment to these neutrals, and their minimum essential needs were met.

*Export controls after the war.* At the close of hostilities many goods remained in short supply, and export licensing procedures were continued. At that time, supply considerations governed the issuance of export licenses. In view of the post-war inflation, an attempt was made to utilize export controls as a counter-inflation measure. If the licensing officials thought that the prices of goods destined for export were too high, export licenses were refused. This application of export controls did not prove successful and was abandoned. Of course, the licensing of goods in short supply always has a built-in counter-inflationary effect by reducing demand.

When supply shortages were resolved in the 1950's, export controls were continued for strategic reasons in the cold war against the Communist Bloc nations. Recognizing that it would be foolish to supply these powers with the sinews of war, many items which were useful to the war potential of the U.S.S.R. and some of its satellites were placed on the Positive List, subject to export licensing. No trade of any kind is allowed with Communist China or in any goods suspected of being of Chinese origin. The United States has obtained the cooperation of some nations of the free world in enforcing its export controls and in preventing the trans-shipment of export-licensed products to Communist destinations.

In time of war, these controls, as a part of the blockade and as means of conserving and controlling the international distribution of goods in short supply, have a useful role. Their use as a means of economic warfare in time of cold war is doubtful according to some students.

They reason that a refusal to export a strategic item to Russia does not necessarily deprive that country of the product. All that the U.S.S.R. needs is a blueprint or a prototype of a product and it soon will be able to produce it. Export controls only bring the U.S.S.R. to divert some of its resources from industries for which it has a comparative advantage to those for which it is at a comparative disadvantage. Although this may prove more or less costly to the Soviet Union, these students point out, in a country so richly endowed with resources it is not a very effective cold war measure.

These students argue that it would be better for the United States to supply Russia with the products which it desires and thus to prevent it from attaining a higher degree of self-sufficiency and making it as dependent as possible upon outside sources of essential and strategic goods. Then, if the cold war turns hot, the United States can apply export controls together with other elements of the blockade with telling effect. Forced to produce some of the matériel of war which it formerly imported, a sharp blow could thus be dealt Communist war-making potential.

*Embargoes.* Embargoes involve the prohibition of certain or all exports to specified destinations and of all, or certain, imports from designated sources. It is customary to refer to these controls over exports as *embargoes* and, when applied to imports, to term them *import prohibitions*. Embargoes are an old form of trade barrier which have been used in the past by various nations. They are employed principally for three purposes: as means of retaliation against the acts of a foreign nation in the hope of bringing that nation to terms, as weapons in both hot and cold wars; and as means of reserving goods for the embargoing nation's economy. In time of war, of course, all trade with the enemy is embargoed.

The United States has applied embargoes from time to time on specific groups of both imports and exports for various reasons. The importation of cattle, sheep, swine, fresh or frozen meats from countries where the foot-and-mouth disease or rinderpest prevails is prohibited. Imported goods made by convict labor are likewise embargoed. Obscene or traitorous publications, lottery tickets, goods protected by trademarks, unless sanctioned by the owner, may not be imported. The Defense Production Act of 1950 embargoed the import of certain agricultural commodities which might impair domestic production, interfere with the storing or the marketing of domestic commodities or unduly burden the government price-support program. The export of tobacco seeds and plants from the United States is only permitted with the written permission of the Secretary of Agriculture and upon the pre-

sentation of proof that they are to be used for experimental purposes only.

Certain Central American countries have embargoed the export of mahogany and mahogany logs to preserve dwindling supplies of this wood and to aid in programs of mahogany reforestation. Mexico embargoed the export of live lobsters and clams and only allowed the shipment of cooked lobsters and shucked clams in an effort to protect her packing industry. The export of raw alligator skins was forbidden by Peru as was that of natural gas from Alberta, Canada to preserve domestic supplies.

*Exchange controls.* Where countries suffer from shortages of foreign exchange, import controls of various types afford but partial relief. They may reduce the total volume of the imports of goods and services, restrict imports to goods which are considered essential, channel foreign purchases into soft currency sources and thus serve to conserve stocks of hard currency exchange. They do not, however, prevent loss of exchange due to the outflow of capital. In addition, where fixed foreign exchange rates are maintained, especially if they are overvalued, pegging operations involving government purchases of its own exchange to support the rate may prove expensive. Exchange controls provide a solution to these problems and reinforce import controls as well.

Under the free exchange systems, trading in foreign exchange is subject only to negotiable instruments laws, legislation relating to banking and finance and financial custom. Within this framework, trading is free of restraint and the resulting rate of exchange is one of the few remaining prices established under conditions of relatively free competition.

Exchange controls substitute government monopoly and monopsony of exchange for the competitive market. Modern exchange controls date principally from the thirties when they were used as counter-depression measures to protect thin foreign exchange reserves. Under most systems, the government central bank is given a monopoly of the sale of foreign exchange and a monopsony of its purchase. All those who receive foreign exchange are obliged to sell it to the government central bank either directly or through private banks appointed to act as agents for this purpose. These sales of foreign exchange to the central bank are made at officially fixed prices, generally slightly below the established par of exchange, and are reimbursed in local currency.

All foreign traders who need foreign exchange to pay for their imports or their investments abroad are required to purchase it from the government central bank or its agents. These purchases are made against payment in local currency at a price slightly above the official

par of exchange. Thus if a country has a currency unit called the crown with a fixed par of 80 crowns to the dollar, the central bank might buy dollars from local exporters at a price of 79-7/8 crowns to the dollar and sell dollars to importers at a price of 80-1/8 crowns per dollar. The price differentials reimburse the central bank for its administrative expenses and can be set to yield either a small or a substantial profit.

Although those who earn foreign exchange must sell it to the central bank, traders who require it for their imports or investments are not necessarily sold foreign exchange as a matter of right. Such sales are generally made under licenses granted only for approved purposes. Thus, foreign exchange might not be sold to a trader for the import of non-essential silk neckties, but it might be granted for the purchase of essential coal.

One of the problems associated with the administration of export controls is the proper allocation of exchange among the various types of goods and services which the inhabitants desire to import, among the many attractive investment opportunities abroad and among the several sources of import supply.

In many countries where import controls are used, administrative procedures have been simplified by providing for automatic allocation of foreign exchange whenever an import license is granted. Exchange controls have been found convenient for a variety of other purposes. It is possible by their use to permit or to discourage a number of transactions: to protect home markets, to discriminate in favor of, or against, certain nations, to serve goals of nationalism and economic warfare.

During World War II, when the belligerents needed many imports and had few exports to pay for them, exchange controls formed an essential feature of their wartime economies. At the end of the conflict the output of the participating nations remained at a relatively low level. In addition, some nations, which had earned large quantities of foreign exchange through their exports to the belligerents, launched post-war programs of development which required amounts of imported capital and equipment in excess of their holdings of foreign exchange. As a consequence, exchange controls were continued by many countries after the end of the war.

The International Monetary Fund, the General Agreement on Tariffs and Trade, the Organization for European Economic Cooperation, the European Payments Union, as well as the United States, endeavored to reduce or eliminate these controls which some nations continued even after their economies had been restored and their foreign exchange reserves reconstituted. These efforts eventually met with a certain degree of success. In 1958 thirteen European members of the

Fund introduced non-resident currency convertibility. By 1961 a large number of members had signified their intention of no longer relying upon the transitional period controls provided for in Article XIV and have accepted the obligations of Article VIII (avoidance of exchange restrictions and currency convertibility) of the Fund Articles of Agreement. Although exchange controls have not been entirely eliminated, they are on the decline and no longer play the restrictive, protective and discriminatory roles which they did in the thirties and the immediate post-war years.

### State Trading

*The U.S.S.R.* Reliance upon private rather than state enterprise is one of the many differences which separates the free capitalist world from the Communist nations. Those nations under communism, socialism, or state capitalism, place some of their foreign trade in the hands of state-owned or controlled enterprises. The capitalist countries of the free world rely largely, but not always exclusively, upon free enterprise for their foreign trade.

The Russian state foreign trade monopoly, established on April 22, 1918, gave the government virtually complete control of foreign trade. In 1918, Russian foreign trade was at a low ebb, consequently this monopoly was in the nature of a token gesture. Under the New Economic Plan (NEP) of the twenties, state monopolies were curtailed in favor of private enterprise, but in 1928 the NEP came to a close and a planned economy under state monopoly took its place.

Foreign trade is now under the domination of the Soviet Ministry of Foreign Trade and is administered by trading corporations, which deal with specific products. In some foreign countries these U.S.S.R. monopolies are represented by a single trading agency such as Amtorg, located in New York. Some binational trading companies, however, have been established which combine the trading activities of the U.S.S.R. with those of one of its trading partners and are jointly controlled by both governments, in theory if not in practice.

Although the results attained by the Soviet foreign trade combines may not be impressive by Western standards, considerable progress has been made since the time of the Czars. In addition, they have achieved another Soviet objective. Formerly, much of the trade of Soviet satellites and other Communist countries was directed toward the West, now the bulk of it takes place with the U.S.S.R. Through foreign trade, Russia has been able to integrate its economy with that of its satellites and the Chinese Communist Bloc thus permitting each member of this large trading area to specialize in the production of specific groups of

goods. Although the dissemination of public information is not one of the outstanding attributes of the Soviet Universal State, the available data indicate that the U.S.S.R. has been the principal beneficiary of this trade, gaining not only the benefits of specialization but profiting from price differentials imposed upon its trading partners.

In trading with the free capitalist countries of the West, the Soviet possesses a number of advantages which it has used on several occasions and which hold disturbing possibilities for the future. The Soviet trade monopolies, according to their own statements, follow those standard commercial practices which appear to be the most advantageous at the time. In the early thirties the most "advantageous practice" justified the U.S.S.R. in dumping large amounts of goods on the markets of the West. It has also sold large quantities of tin, petroleum and grains at less than the world price and is still continuing to do so. Being both a monopoly and monopsony, these state enterprises can adjust their buying and selling prices to take advantage of both demand and supply price elasticities. They can apply trading policies to disrupt world trade, because unlike private business a state monopoly system does not need to make a profit on each transaction. What one combine loses can be made up by the gains of another or the difference may be taken out of the pockets of the Russian people.

*State trading by the Western powers.* Some Western governments employ state trading for certain products and upon occasions where this form of foreign trade is either useful or necessary. In France, the government tobacco *Régie* has a monopoly of the manufacture, sale and export of French tobacco products and a monopsony of French domestic purchases and imports of tobacco and tobacco products. Similar French monopolies are the playing card and match state *Régies*. These are what are known as fiscal monopolies, established to augment government revenues. The Marketing Boards of Australia, the Caribbean and some former British African colonies, created to bring order into the production and distribution of certain products, engage in both foreign and domestic state trading.<sup>1</sup>

During World War II the British government engaged in a series of bulk purchase programs and bought some of the farm and extractive products of certain Latin American countries, New Zealand and Australia. The American government joined the British, during this War, in the purchase of some Latin American raw materials to prevent competitive bidding from raising prices. These two governments also engaged in the preclusive, or preemptive, purchase of strategic raw mater-

ials in various countries in an effort to prevent them from falling into Axis hands. In conjunction with its raw materials control programs during that War, the United States government acted as a monopsony in the purchase of a variety of critical and strategic raw materials to insure the orderly rationing of supplies.

*International standards for state trading.* The possible abuses inherent in state trading have led some nations to take steps to protect themselves. Since the inception of the Hull Reciprocal Trade Agreements Act of 1934, clauses have been inserted in various Trade Agreements providing that, if foreign governments maintain import monopolies, they will follow "price, quality, marketability, and terms of sale, which would ordinarily be taken into account by a private commercial enterprise interested solely in purchasing such product on the most favorable terms." The Charter of the ill-fated International Trade Organization (ITO) stipulated that foreign trade monopolies must observe the usual commercial considerations in their international dealings and provided for negotiations between state-trading and non-state-trading countries to guarantee equitable treatment on prices and quantities exchanged. The General Agreement on Tariffs and Trade (GATT), Article XVII, provides checks on the discriminatory actions of state-trading monopolies and requires that they follow the rules of ordinary commercial practice in their transactions.

### **Bilateralism**

In the United States, many, but not all, programs of wartime government intervention were quickly abandoned after the war. In Western Europe, where socialist philosophy had made greater progress, there was a tendency for controls to remain. In Eastern Europe, under the hegemony of the USSR, the trend was toward state ownership of industry. Bilateralism may be said to occupy a position somewhere between state-trading and private enterprise. Although trade remains in private hands, government agreements control its direction and extent. Bilateralism refers to a variety of trade and payments arrangements made between two or more nations which direct exports and imports to and from the participants in the arrangement rather than multilaterally among a large number of countries. These agreements provide channels through which international trade must flow and which can be reinforced by import and exchange controls.

During the 1930's both domestic and foreign trade declined substantially. Since trade did not display a strong tendency to reestablish itself through the operation of free economic forces, governments undertook to start it moving upward again. They negotiated bilateral

agreements designed to promote the exports of the stricken industries. Although not widely employed during the second World War, they were revived during the difficult post-war years to help in solving the persistent problems of international payment. Bilateralism resembles barter in many respects.

*Clearing agreements.* Under these arrangements, the participating governments establish lines of credit in favor of each other, each government specifying the types of goods which it seeks to export and import. When an importer in one country purchases goods from an exporter, he does not need foreign exchange but simply pays his government the local currency equivalent to the value of the imported goods. The exporter in the other country is not paid by the importer in foreign exchange; he is reimbursed in local currency by his government. At the end of the trading period, the two governments settle the balance which remains either by the extension of credit, the shipment of additional goods, foreign currencies or gold. These agreements strongly resemble bank clearing house operations.

In some of these clearing agreements the goods to be exchanged are spelled out in some detail, in their simplest form an exporter in one country agrees to ship specified goods to an importer located in the other and to accept a certain amount of scheduled imports in return. These arrangements are sometimes called *private compensation agreements* for the trade takes place between private traders of each country. The private compensation agreement requires the exporter also to act as importer, and the number of firms which can engage in these transactions is therefore limited.

Italy and Belgium concluded a trade and payments agreement at the end of World War II which provided for the exchange of a selected list of products. The transactions were to take place in Belgian francs and the Italian Foreign Exchange Office opened a credit of 100 million Belgian francs with the National Bank of Belgium. The agreement stipulated that any credits remaining after the conclusion of the specified transactions were to be liquidated in gold or other foreign exchange at the rates of exchange established by the International Monetary Fund.

*Payments agreements* The payments agreement covers a wide range of transactions and, unlike clearing or private compensation agreements, utilizes bills of exchange and other instruments to make payment rather than a clearing mechanism. They are often used for transactions in capital and include a wider range of goods and services than clearing arrangements. Each country agrees to a specified rate of exchange and to make foreign exchange available for certain transactions which, in the absence of the agreement, would not have been

allocated. When a given country finds that it is importing more than it is exporting, it may attempt to persuade the export surplus country to make foreign exchange available for additional imports to bring the international accounts more closely into balance. Unless the surplus nation is willing to agree to this, the deficit country can threaten to curtail its imports.

These arrangements are also used where one country is in debt to another and proposes to liquidate the debt by increasing its exports to its creditor. In such cases, the debtor country agrees to utilize a portion of the additional foreign exchange earnings for the reduction of its debt. The remainder, if any, is used to increase the debtor country's imports from its creditor.

An agreement made between Denmark and Finland at the end of World War II provided for Danish imports of newsprint, timber and other materials from Finland having a value of 180 million Danish crowns, and for Finnish imports of Danish machinery, textiles and other manufactures totalling 150 million Danish crowns. The difference of 30 million Danish crowns was to be applied to Finland's debt to Denmark, which arose as a result of previous transactions.

*Barter agreements.* Exchange-short nations frequently execute barter agreements with another country whereby one nation agrees to ship a given amount of a commodity to another in exchange for other specified goods. Thus, in 1949 India agreed to export 40,000 metric tons of certain jute manufactures to Argentina in exchange for 390,000 metric tons of wheat. Another barter agreement between Mexico and Japan, executed in 1950, provided that Mexico would export specified amounts of sugar against Japan's export of certain types of railroad equipment and rails.

*Advantages and disadvantages of bilateralism* Bilateralism is a poor substitute for the more efficient systems of multilateral trade. It does not permit buyers and sellers to seek the best markets and sources of supply but ties trade to the parties to the agreement. It may turn the direction of trade away from those channels which international specialization and the theory of comparative advantage indicate as the most effective. Bilateralism interferes with economic freedom, works against the free market mechanism, and substitutes the judgment of government authority for that of the market place. In addition, these arrangements present opportunities for sharp practices involving prices, quantities and types of merchandise exchanged.

In spite of these disadvantages, bilateral agreements have been widely employed and in certain cases may have increased the trade of the countries which used them. As foreign exchange shortages de-

clined and as economies became stronger these agreements have tended to disappear, and after the organization of the European Payments Union in 1950 they were not widely utilized by the governments of Europe.

### Cartels and Monopolies

From a businessman's point of view, free competition may not always be desirable because under pure competition profits have a tendency to disappear. In addition, under free, atomized competition of small units there are a very large number of competing firms, and each one may be too small to take full advantage of the economies of scale. There are also strong forces in industries of the decreasing cost type which motivate a business enterprise to eliminate competitors, obtain a larger share of the market, produce at lower costs, sell at reduced prices and still make a profit. The consumer, in such cases, may often be better served where large enterprises prevail.

*Reasons for the growth of cartels* Some of these reasons, among others, account for the formation of international monopolies or cartels. Assume that an American pharmaceutical company develops a new and effective antibiotic at considerable research expense, which is protected by patents and trademarks. The company spends substantial sums of money in developing United States, Latin American and Canadian markets for its new product. An Italian pharmaceutical house approaches the American firm to obtain a license to manufacture this antibiotic. If the American firm decides to license the Italian house to make and sell the product, it would obviously not allow the Italian company to sell the product on the American continent where the United States firm had spent large sums in promoting it. A condition of the license to manufacture the product would undoubtedly be agreement on the part of the Italian firm not to sell it in these markets. Such a licensing arrangement constitutes a cartel in the international trade of this new pharmaceutical.

The international cartel is an offshoot of domestic monopoly dating to Mercantilist days when such monopolistic enterprises were often created by government grant. In recent times, cartels developed on a large scale in Europe in the period between the first and second World Wars, when keen competition and excess capacity prevailed in many lines of business. Some United States firms participated in a few of them in spite of American anti-trust legislation. American business suffered from the competition of those of which it was not a member and obtained the passage of the Webb-Pomerene Act in 1918, which permitted combinations and joint, non-competitive sales corporations

for international trade without violating anti-trust statutes as far as international operations were concerned.

*Types of cartels.* There is a wide variety of cartels. Some of them are price-fixing arrangements; others provide for the division of world markets; a number limit output by assigning quotas to each producer; others restrict or limit the operations of the participants to the manufacture of specified products or components; some provide for the interchange or the pooling of patents, while a few combine these various features.

Cartels have been formed in a number of industries, especially in the chemical industry. One of the better known of these involved the Imperial Chemical Industries of England, the E. I. duPont de Nemours Company in the United States and the I. G. Farbenindustrie in Germany. This cartel divided the world into areas, assigning certain ones to specified participants, and during its life successfully controlled the manufacture, sale and price of a long list of chemical products.

In another field, a cartel was formed between the German Krupp firm and the American General Electric Company for the purpose of pooling patents relating to the production of tungsten carbide. This cartel established prices, divided sales areas and provided for the distribution of profits resulting from its pooled patents.

*The economics of cartels.* The principal objections to cartels lie in their trade-reducing effects and price-fixing activities. They may be used politically as an aid in attaining certain national objectives and to increase a nation's war potential. Most cartels are created in the interest of producers rather than consumers and constitute a further manifestation of foreign economic policy-making on the private business level. Partisans of cartels maintain that they tend to stabilize an industry and eliminate some of the wastes of competition. Where they permit decreasing cost types of industry to take advantage of the economies of scale and pass these economies on to the consumer, they are of advantage to the world economy.

It is difficult to generalize concerning the economic effects of cartels. Doctrinaire attitudes for or against them are of little help in the solution of the problems which they raise. The net results of their operations must be determined by theoretical or empirical analysis in each individual case.

*Solution of the cartel problem.* The attitude toward cartels which prevails in the United States is an extension of that toward domestic monopoly. Americans oppose monopoly, as its many anti-trust laws bear witness. In Europe, the attitude toward monopoly and cartels has often been one of disinterest, tolerance or even positive encouragement. This

attitude, however, is changing. The European Coal and Steel Community opposes them and the Common Market, in Article 85 of the Treaty of Rome, decries them. In addition some of the European countries have adopted anti-trust legislation, and the attitude toward trusts abroad is approaching that held in the United States.

The problem of monopolies and cartels remains one of the unsettled issues of both domestic and foreign economic policy. In spite of strong opposition, monopolies continue in the United States and abroad. A new approach to the problem of international cartels is needed—an approach which will preserve the advantages which these organizations possess and at the same time eliminate possible abuses.

Barriers to trade, including the tariff, are of less importance today than they were in the thirties and the immediate post-World War II days. They continue, nevertheless, to have important effects, and the economics of these barriers is examined in the following chapter.

## QUESTIONS AND PROBLEMS

1. When is a nation justified in using export controls? Why has the United States continued to use them? Have they been effective?
2. Why are quota controls placed on imports? What are the effects of these quotas?
3. Are both import and exchange controls ever needed? If exchange rates were allowed to float freely, would exchange controls still be required? Why or why not?
4. If a nation is undergoing severe inflation, what types of international controls should it adopt, if any?
5. Should the United States embargo all trade with the Soviet Union? Why or why not?
6. What are the advantages and disadvantages of exchange controls as compared with a free market in exchange?
7. Should the United States adopt state trading in its foreign trade with the Communist nations employing this system? Why or why not?
8. Why would a government using state trading need to know the demand and supply price elasticities of its traded product?
9. Should GATT agreements forbid state trading? Why or why not?
10. Write a note on bilateralism, explaining its different forms and showing the various circumstances under which each type might be used.
11. Explain the conditions under which cartels serve a useful purpose. Could cartels be eliminated by unilateral action on the part of the United States?
12. Using assumed data, explain the price effects of a cartel which restricts the output of the participants.
13. Why are trade barriers of less importance today than they were in the years immediately following the second World War?
14. Would completely free international trade be a desirable goal? Justify your answer.

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## The Economic Effects of Trade Restrictions

In one of the classic works on the subject of the shifting and incidence of taxation, Edwin R. A. Seligman, speaking of import duties, stated

"The elements that enter into the equation of international demand are so numerous and so complex that an investigation of the actual effects of a tax upon any one class of commodities would require for its proper solution not only the acquaintance with the details of the theory itself, but also an intimate knowledge of all of the forces influencing the supply of, and the demand for, the commodities affected in the two countries immediately concerned as well as in all the other countries that constitute the world market."<sup>1</sup>

Although the precise effects of the import tariff are difficult to determine, as Seligman indicates, modern economic theory through its graphical methods of analysis has provided some important tools for the determination of the general character of the economic impact of the tariff and other trade barriers. In the limited space devoted to the topic, only the principal methods of analysis are examined.

<sup>1</sup> Seligman, Edwin R. A. *The Shifting and Incidence of Taxation* (2nd ed.). New York: The Macmillan Co., 1902, pp. 300-301.

## The Shifting of Tariffs on Imported Goods

*Mechanism of the shifting.* An American importer is engaged in the watch assembling trade. A watch assembler is usually an importer of Swiss watch movements who buys domestic cases, straps and presentation boxes, assembles these components and sells the finished watch to the retail jewelry trade. Assume that the cost of the movements imported by this assembler, laid down in New York, before the payment of the duty, came to exactly \$12.00 each. The American-made cases cost \$5.00, the domestic straps \$0.75 and the boxes \$0.25. The labor of assembling and of making adjustments came to \$2.00 for each watch. The cost of these parts and operations totals \$20.00 for each watch.

Before withdrawing the movement from the customs house in New York, the assembler had to liquidate the applicable duties which amounted to \$4.25 for each movement.<sup>2</sup> Since the cases, straps and boxes were of domestic origin, they involved no import duty. Disregarding transportation and handling costs, the total cost of the watch including the duty was \$24.25. If this particular assembler worked on a percentage mark-up basis, and desired a 25 per cent gross profit on each watch, he would sell it to the retail jeweler at about \$30.00 (125 per cent of \$24.25 = \$30.31). Many retail jewelers endeavor to obtain a 100 per cent mark-up on watches. If this were the case, the jeweler would offer the watch to his customers for \$60.00 (200 per cent of \$30.00 = \$60.00) to which he would add the applicable 10 per cent federal excise tax, amounting to \$6.00, giving a total retail price of \$66.00.

If these percentage mark-ups and excise taxes are applied to the customs duty alone and not the entire watch, the results are surprising. The assembler's mark-up of the duty comes to 25 per cent of the tariff of \$4.25 or \$1.06. Added together, the duty plus the mark-up amount to \$5.31. When the retail jeweler adds 100 per cent to his cost, the duty increases by 200 per cent of \$5.31 to \$10.62. The excise tax adds 10 per cent of \$10.62 or \$1.06 and the total comes to \$11.68. The original tariff duty was \$4.25, but when the percentage mark-ups and the excise tax are added, the "duty" paid by the consumer has *pyramided* to \$11.68 or almost three times the original amount paid by the assembler.

<sup>2</sup> The tariffs on watch movements are a complex type of specific duty and are given in paragraph 367 of the Tariff of 1930 as amended by the Trade Agreements in effect in 1961.

If flat, instead of percentage, mark-ups were used by the various parties, the duty would not have increased as much but, since the percentage formula is widely employed, the illustration is typical of many import transactions. *The burden of an import tariff on the consumer cannot be gauged by consulting the rates of duty alone. The mechanics of the transaction and the practices of the trade must also be taken into account*

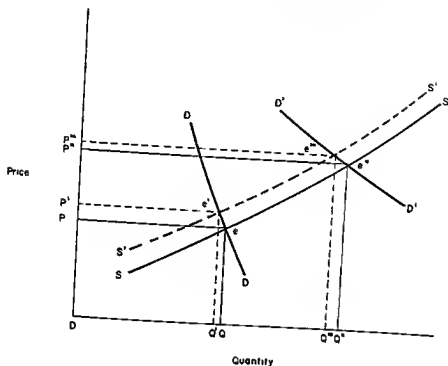
*Shifting and incidence: general concepts.* The impact of a tax refers to the person or organization which pays the tax to the collector in the first place. In many cases the *burden* of the tax can be *shifted* from its point of impact to some other person or institution on which its *incidence* is then said to rest. The shifting process is a price phenomenon, a problem in demand and supply analysis, and is manifested when the tax is shifted forward, as is generally the case with the tariff, by an increase in prices. A customs tariff usually raises the supplier's asking price, reduces the volume of the supply or both.

In the analysis of shifting both supply conditions and demand price elasticities are important. Economists usually recognize three types of long-run industry supply conditions: supply produced under conditions of constant, increasing and historically decreasing costs. Demand is generally classified into two broad groups: relatively elastic and relatively inelastic demand. In addition, the exchange of the products subject to a tariff may take place under conditions of relatively perfect competition, monopoly or monopolistic competition. The analysis of the shifting of the import tariff which follows takes these elements and factors into account.<sup>3</sup>

*Market supply already produced.* The simplest case of the shifting of the tariff on imported goods is that for a market with an already produced supply of imported goods and is illustrated graphically in Chart XXI 1 showing the partial equilibrium under conditions of both inelastic and elastic demand. Demand, it is assumed, did not change after the payment of the tariff duty. In this case, the tariff results in an increase in price and a decrease in the amount exchanged, the magnitude of these changes depends upon the duty levied, the slope of the supply and the elasticity of the demand curves

## CHART XXI.1

SHIFTING OF THE TARIFF ON IMPORTED GOODS  
MARKET SUPPLY—INELASTIC AND ELASTIC DEMAND



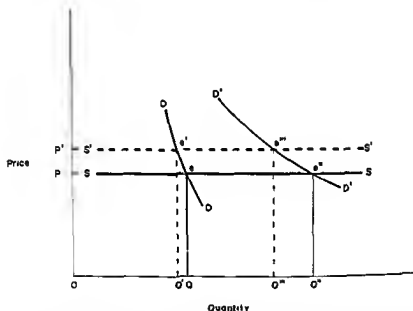
$SS$  represents the suppliers' offer schedules based on their reservation prices before the payment of the duty, and  $S'S'$  after.  $DD$  represents inelastic, and  $D'D'$  elastic demand for the product. Point  $e$  indicates the pre-duty partial equilibrium of supply and inelastic demand and point  $e'$  after duty payment. There is a small decrease in the quantities exchanged, under inelastic demand, from  $Q$  to  $Q'$ , and a larger relative increase in price, from  $P$  to  $P'$ . Point  $e''$  indicates the pre-duty partial equilibrium of supply and elastic demand and  $e'''$  after. There is a relatively larger decline in the quantities exchanged, under elastic demand, from  $Q''$  to  $Q'''$ , and small increase in prices, from  $P''$  to  $P'''$ .

*Long-run period—perfect competition—constant costs.* A long-run period, for purposes of this analysis, may be defined as at least a full production period where supplies of imported goods are being produced as they are sold and where there are few external changes in technology. The supply curve has the form of the cost curve, for the offer schedules of sellers are functions of costs of production. Under conditions of perfect competition, no one firm has a monopoly of, or

control over, the market and many firms compete.<sup>4</sup> Constant cost industries are those where the per unit costs of production remain relatively the same over the production schedule. Such industries are those where the economies of scale do not prevail and where the industry employs large amounts of manpower relative to capital and has easily reproduced inputs. Chart XXI.2 illustrates the shifting of a customs tariff on imported goods under these conditions.

CHART XXI.2

SHIFTING OF THE TARIFF ON IMPORTED GOODS  
LONG-RUN—PERFECT COMPETITION—CONSTANT COSTS



SS represents supply before the payment of the duty and S'S' after, DD, inelastic, DD' elastic, demand for the products. Point e represents the pre-duty partial equilibrium of supply and inelastic demand, e' after, e'' that for supply and elastic demand before duty and e''' after. The pre-duty price is OP and after payment is OP', the same for both elastic and inelastic demand. With inelastic demand, the quantity exchanged drops but slightly after the payment of the duty, with elastic demand, the quantities exchanged decline substantially.

<sup>4</sup> The analysis presented here applies, unless otherwise noted, to an entire industry, rather than a firm, and the cost or supply schedules represent average costs. For a discussion of the shifting of commodity taxes—the import tariff is a form of commodity tax—in relation to individual firms, see Groves, Harold M. *Financing Government* (5th ed.). New York: Henry Holt and Co., 1958, pp. 105-147.

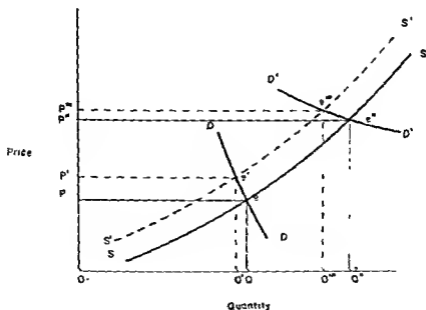
In this case, the prices rise by the full amount of the duty paid. Varying elasticities of demand are reflected, not in the price, but in the quantities bought and sold.

*Long-run period—perfect competition—increasing costs.* Increasing cost industries are those where, after a certain output has been attained, increased quantities of the product can only be obtained at higher per unit costs. Such cost curves are characteristic of some farm and

### CHART XXI 3

#### SHIFTING OF THE TARIFF ON IMPORTED GOODS

#### LONG-RUN—PERFECT COMPETITION—INCREASING COSTS

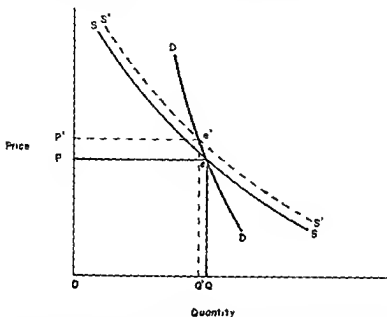


SS represents the supply schedule before the payment of the tariff duty,  $S'S'$  after; DD an inelastic and  $D'D'$ , elastic demand. Points  $e, e', e'', e'''$ , the partial equilibria of demand and supply. With inelastic demand, almost the full amount of the duty is shifted as indicated by the prices  $OP$  and  $OP'$ . The quantities exchanged,  $OQ$  and  $OQ'$ , show but little decrease. With elastic demand, the rise in price attributable to the duty is small, from  $OP''$  to  $OP'$ , but the decline in quantities exchanged is relatively large, from  $OQ''$  to  $OQ'''$ .

## CHART XXIA

## SHIFTING OF THE TARIFF ON IMPORTED GOODS

PERFECT COMPETITION—HISTORICALLY DECREASING COSTS—INELASTIC DEMAND



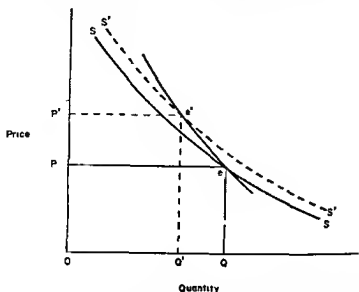
$SS$  represents the pre-duty supply,  $S'S'$  after  $DD$  represents inelastic demand. Supply and demand are in partial equilibrium, before the duty, at point  $e$  where the price is  $OP$  and the quantities exchanged,  $OQ$ , and after, at point  $e'$ , where the price is  $OP'$  and the quantities exchanged  $OQ'$ . The price rises from  $OP$  to  $OP'$ , by an amount slightly more than the duty, and the quantity exchanged drops slightly from  $OQ$  to  $OQ'$ .

of his product, computed by dividing total revenue by the number of units sold and the marginal revenue, or the amount that the sale of an additional unit, or increment, of product, brings. In connection with production activities, the monopolist is interested in his average costs, or his total costs divided by output, and marginal cost, or the cost of the last or an additional increment of output.

If the monopoly possesses accurate knowledge of costs and sales, it would continue to produce up to the point where marginal revenue equals marginal costs. Were it to stop production before reaching this point, it would find that more money could be made by continuing to sell and produce since the added marginal revenue would be greater than the marginal costs. If it continues to produce and sell beyond this point, the monopoly will find that the additional revenue from sales

## CHART XXI.5

SHIFTING OF THE TARIFF ON IMPORTED GOODS  
 PERFECT COMPETITION—HISTORICALLY DECREASING COSTS—ELASTIC DEMAND



$SS$  represents the pre-duty supply,  $S'S'$  after.  $DD$  represents elastic demand. Supply and demand are in partial equilibrium, before the duty, at point  $e$  where the price is  $OP$  and the quantities exchanged,  $OP$  and after, at point  $e'$  where price is  $OP'$  and quantities exchanged,  $OQ'$ . Prices rise by an amount greater than the duty and the quantity exchanged declines substantially.

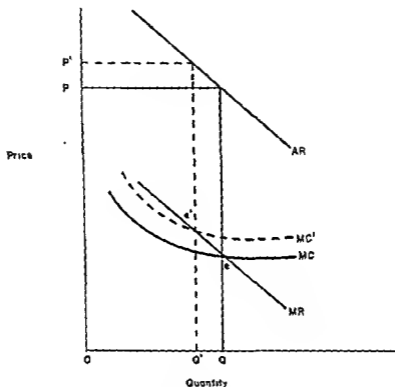
will not bring in enough cash to cover the marginal costs of production. The points,  $e$  and  $e'$  on Chart XXI.6 represent the equilibria of marginal costs and revenue for imported goods before and after payment of the duty.

If a line is projected vertically from  $e$  or  $e'$  to the average revenue curve, the price at which the goods are sold is ascertained. Obviously, the monopoly must price on the basis of average revenue for, if it prices on the basis of marginal revenue, it will be pricing too low and total receipts will not cover total costs. If a line is projected from point  $e$  or  $e'$  to the quantity axis, the volume exchanged can be determined.

The monopolist was assumed to be operating under conditions of decreasing costs, to have been unable or unwilling to raise his selling prices after paying the duty and to face a demand of a given elasticity. All monopolies do not control industries of decreasing costs; some have increasing and some, constant, costs and some do raise their prices

## CHART XXL6

SHIFTING OF THE TARIFF ON IMPORTED GOODS  
MONOPOLY—HISTORICALLY DECREASING COSTS



MC represents the marginal costs, MR the marginal revenue, and AR the average revenue. The monopoly would produce until marginal revenue equaled marginal costs, point *e*, partial equilibrium, where *OQ* quantities are exchanged at a price of *OP*. After the payment of the duty, the marginal cost curve is *MC'*, giving a new partial equilibrium point *e'* with *OQ'* quantities of goods exchanged at a price of *OP'*.

when a tariff is imposed. The principles, however, of the shifting of import duties under other costs, selling prices and demand elasticities are the same. In the case at hand, the price rose by more than the amount of duty paid and the quantities exchanged declined substantially.

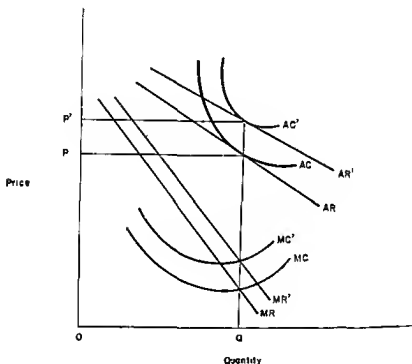
*Monopolistic competition—historically decreasing costs.* Under monopolistic competition, there are a number of firms in each industry and no one firm completely dominates the market. The products of each firm in the industry are differentiated from those of the others by

variations in design, by advertising, marketing and merchandising, although those of any one firm may generally be substituted for those of the others without great difficulty. Soaps, toothpaste, radios, television sets, among many others, are examples of this type of industry.

Entrance into, and exit from, the industry is relatively easy. The demand, or average revenue curves, of firms in this industry generally slope downward and the average cost curves take the characteristic

### CHART XXI 7

SHIFTING OF THE IMPORT TARIFF  
LONG RUN—MONOPOLISTIC COMPETITION—DECREASING COSTS



*AC* represents average costs before, and *AC'* after the payment of the duty, *MC* the pre-duty marginal costs and *MC'* after *AR* represents the average, and *MR* the marginal, revenue respectively. The enterprise at first continues to produce, after paying the duty, up to the point where the *MR* curve crosses the *MC'* curve but this leaves it with a loss. Competing firms, operating similarly at a loss, leave the trade, resulting in an increased demand for the products of the remaining firm as the curves *AR'* and *MR'* indicate. Equilibrium is reestablished when the *AC'* curve is tangent to the *AR'* curve. The new equilibrium price moves from *OP* to *OP'* and will exceed the old pre-duty price by the amount of the tariff. The output of the firm is at *OQ* both before and after the payment of the duty.

U form. Equilibrium for such a firm is attained at the point where the average cost is tangent to the average revenue curve. The import duty raises the average, AC, and the marginal, MC, cost curve to AC' and MC' respectively as indicated on Chart XXI.7. In the assumed case, the exporting firm is able to raise its selling prices to a point consistent with the duty, as shown by the shift of marginal revenue from MR to MR' and average revenue from AR to AR'.

The effect of an import tariff upon the exported products of this type of firm is to raise the price by the amount of the duty paid. There is no change in the quantity of goods exchanged due to the tariff, which remains the same in both cases.

### Reaction of Foreign Countries and Industries to Import Tariffs

Nations which encounter new or increased tariffs will not necessarily remain idle or accept the situation without some form of retaliation. These nations and their industries are likely to use whatever means they can to overcome the effects.

*Tariff retaliation.* If the United States import duty were increased as a result of an escape clause action under the Reciprocal Trade Agreements Act, other countries would probably retaliate by denouncing their reciprocal reductions on certain United States exports. Thus some of the burden of the tariff increase would be borne by the American exporting industries affected by the reciprocal tariff increase. In analyzing the economic effects of new or increased tariffs, the counter-effects of tariff retaliation should be taken into account and the decision on tariff policy might be based on the principle of net advantage or by an answer to the question: Were the benefits resulting from the new or increased tariff equal to the losses resulting from the retaliatory action?

*Reaction by increased efficiency and innovation.* If the market in the country increasing the tariff is large, the industries of the exporting countries might react by attempting to increase their efficiency and lowering the costs of their products. If these exporting industries were able to attain such a result, the effects of the tariff might be nullified. In the graphic analysis outlined in the preceding sections of this chapter, the curves SS' would return to their original levels, SS, and foreign competition would continue just as though the tariff had not been levied or raised. The Swiss watch industry reacted to the United States denunciation of the watch tariff clauses of the Reciprocal Trade Agreement with Switzerland by increasing their efficiency and lowering their prices.

In the case of products where innovation is important, foreign industry, faced with a new or increased tariff in one of its important markets, might react by improving its products, creating new and attrac-

tive features, developing the utility or sales appeal of its goods. These innovations might serve to overcome some of the disadvantages of the tariff, and some of its protective features could thus be lost. The Swiss watch industry also reacted against the United States tariff increase by creating new features, more attractive designs and watchmaking innovations which served to vitiate, partially at least, the effects of the tariff increase.

*Reaction by the development of new markets.* Foreign industries, adversely affected by a new or increased tariff, might attempt to recoup their potential losses through the development of markets in other countries. Of course, there is no harm in this to the protected domestic industries, unless their products are sold on the markets selected for development by the foreign competitors. In such cases, the gain on the domestic market resulting from the tariff might be partially offset by a loss on others.

*Reaction by investment.* Where a foreign firm finds it difficult to compete on overseas markets because of tariffs, they may attempt to vault over the barrier by establishing branches or subsidiary plants in the protected country or by licensing manufacturers in that country to make their products. Many American firms have invested abroad because of these barriers. The European Common Market with its tariff preferences for members is a magnet attracting United States companies to locate abroad to take advantage of the lowered tariffs which prevail among its members.

If many foreign firms establish plants abroad, some of the advantages of protection are lost to the protected domestic industry. Firms which establish these enterprises abroad must pay the wages and other costs which prevail in the host country and compete on relatively even terms with the protected industries abroad. But they do bring competition to domestic industry wherever they locate and nullify at least some of the advantages which trade barriers afford.

### Reaction of Domestic Industry to Tariff Increases

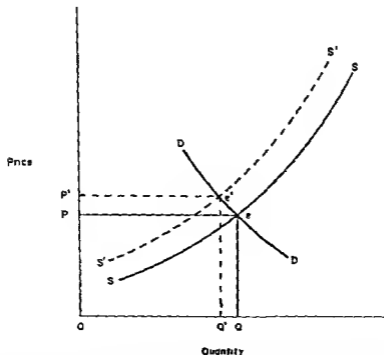
*Effects on prices and quantities exchanged.* As the graphical analysis in the preceding sections shows, the tariff serves generally to reduce the total volume of imported goods and to raise their prices. The decline in the quantity of imports and the increase in their prices give the protected domestic industries a variety of choices. These industries can maintain their prices and benefit from an increased volume of sales, they can raise their prices up to the level of those of the imported goods which pay the tariff; or they can combine an increase in price below

that which the tariff would justify and benefit from a relatively small increase in sales.

If the prices prevailing for the protected goods before the imposition of the tariff were unremunerative, domestic industry might attempt to raise its prices unless it were of the decreasing cost type where the increase in sales and output could operate to bring lower costs. In the case of constant cost industries, there would be no advantage, cost-wise, of an increased volume of sales, and some members of such industries might attempt to raise their selling prices to the point justified by the tariff. For increasing cost industries, a greater sales volume and output might occasion higher costs. These industries might be tempted to raise their prices rather than endeavor to attain a larger output.

CHART XXI B

EFFECTS OF A TARIFF ON DOMESTIC PRODUCTS  
MARKET SUPPLY—PURE COMPETITION



SS represents the pre-duty supply of domestic and imported goods and  $S'S'$  the reduced supply after the imposition of the tariff DD represents the demand for the product. Point  $e$  is the pre-duty partial equilibrium point where the quantities exchanged are  $OQ$  and the price  $OP$ . With the supply reduced, the new equilibrium point is  $e'$ , where the quantities exchanged are  $OQ'$  and the price  $OP'$ . The import duty reduces the amount of goods exchanged and raises the price.

Chart XXI.8 illustrates the effects of a tariff which decreases the imports and consequently the total supply. It assumes that because of higher laid-down prices, fewer foreign goods are imported. This chart illustrates but one condition, that of a market supply of goods already produced by both foreign and domestic producers. In this case, the market supply of the product is decreased, prices rise and the quantities exchanged are smaller.

CHART XXI.9

EFFECTS OF AN IMPORT TARIFF ON DOMESTIC INDUSTRY  
HISTORICALLY DECREASING COSTS—PERFECT COMPETITION

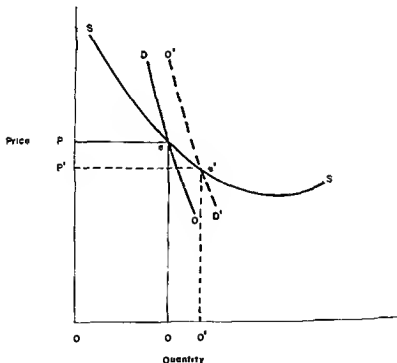


Chart XXI.9 illustrates another situation: the possible effects of a tariff on domestic industry of the historically decreasing cost type operating under competition. The output of the domestic industry constitutes the supply of *home-manufactured goods*, and there is no decrease in its production after the imposition of the tariff. Since the prices of imported goods will be higher after the payment of the duty, some of the demand for the foreign-made goods can be presumed to shift to the domestic products. On Chart XXI.9 this effect is noted by moving the demand curve to the right. As the chart shows, the tariff reduces the price and increases the quantities exchanged. Under other conditions of cost, different curves would be used and the price and quantity effects of the tariff would differ.

### Impact of Quotas, Trade and Exchange Controls on Foreign and Domestic Industry

Although protectionism is seldom the basic reason underlying the use of quotas, trade and exchange controls, they have strong protectionist effects. As the cyclical, balance of payments, fiscal and other motives which led to the employment of these controls disappear, they are often retained for protectionist reasons. The tariff gives the foreign competitor a "run for his money" at least; under these other controls, the competitor from overseas enjoys no such favor. While the tariff affords *relative* protection, quotas, trade and exchange controls protect *absolutely*. Their use enables a government to control the amount of any foreign product or service which may be imported as well as to determine the sources from which they are derived.

*Reaction of foreign industry to quotas and controls* If the country imposing quotas and controls is a relatively unimportant market for the goods of one of its trading partners, it is doubtful that the industries of this partner would take any steps to overcome their disadvantages, for the game would hardly be worth the candle. Where these markets are important, affected foreign industries might be prompted to develop others in areas which had no controls or to establish branches and subsidiaries in the controlled markets to hurdle the trade barriers. There is little else that they could do to overcome the disadvantages for no lowering of prices, no improvements in quality or innovation would necessarily help them gain access to the closed market.

The governments of nations adversely affected by quotas, trade and exchange controls can attempt to negotiate a relaxation of the controls. In addition, if they are in a position to do so, they can take positive steps to improve the foreign exchange reserve holdings of those countries which use them and thus eliminate one of the reasons for

their continuance. There is little doubt that one of the objectives of the Marshall Plan and its successor grant and loan programs was to promote United States exports by providing foreign exchange to reserve-short nations and thus to undercut the rationale which conditioned the controls.

*Reaction of domestic firms to quotas and trade controls.* By either completely excluding some foreign products, or admitting only those goods which come from selected soft currency areas, the total volume of imported goods is reduced and domestic industry benefits from a larger home market for its products. In the case of a tariff, a type of price ceiling is set for similar domestic goods which is, in part the price of the imported article plus the tariff. For imports from soft currency areas, the price limitation is that of the imported articles for which foreign exchange is available. Under a quota system, a limited amount of goods is licensed for import, and the prices of these licensed goods, up to the quota amount, serve to set a ceiling upon those of the competing domestic articles. Beyond the quota, the limits on the prices which domestic producers might demand are increased. Quota, trade and exchange controls, like the tariff, may engender competition on the home market through the establishment of new domestic industries tempted by the relatively high profits which the protected industries enjoy. The advantages which accrue to the protected firms in the first instance may prove of relatively short duration.

### Other Economic Effects of Trade Restrictions

The impact of tariffs, quotas, trade and exchange controls is far-reaching. Trade barriers touch, with a light or heavy hand, almost all aspects of the economy.

*Effects on the terms of trade.* The study of the terms of trade revolves around the analysis of international reciprocal demand or the prices of a nation's imports in terms of its exports. To determine a country's terms of trade vis à vis those of its trading partners, one must weigh its exports against the imports which it receives in return.

When economics was dominated by the Classical School, the value of goods was held to be measured by a single element, labor. It was then considered possible to compare the terms of trade between any two countries by determining the net labor content of exports and equating it against that of its imports. Today, economists realize that such a comparison is not valid for the contents of goods are variable and not homogeneous. In addition, it signifies but little to learn that country A exported X pounds of coffee to country B and received Y units of trucks and Z of farm tractors in return or that the value of the

coffee exports was \$125 million and that of the trucks and tractors \$115 million. For such reasons, the *absolute levels* of the terms of trade are not usually measured, but the *movements* are. The study of these movements is valuable because it reveals whether or not a country is gaining or losing in its international transactions, it answers the question, must a nation utilize an increasing or a decreasing amount of its resources to obtain a given amount of goods, services and capital from overseas?

A protective tariff is likely to alter the terms of trade, and if the demand for a nation's products is large and inelastic it may improve them. If its trading partners require these imports and desire to maintain their purchases of them, they will have to find some means of earning the requisite foreign exchange. They can do this by either of two methods.

The trading partners can devalue their rates of exchange or lower the prices of their exports to induce the protectionist country to increase its imports. If either of these two devices are used, the terms of trade of the protectionist country will have improved, since it will now be importing products which cost less, while maintaining the prices of its exports. Where a tariff improves the terms of trade, it tends, at the same time, to become less protective.

Quotas, exchange and trade controls do not ordinarily have the same effects upon the terms of trade. These controls are not directed toward the prices of imports; they either exclude them entirely, admit them in limited quantities or from specified sources. An exporting nation facing such controls is not likely to obtain the entry of its products by devaluing its rate of exchange or by reducing its prices. However, a nation which is adversely affected by these measures might lower the prices of its exports which are not subject to the controls or, if it can afford it, institute programs of grants and loans to provide other countries with its exchange in an effort to induce them to reduce their barriers.

*Effects on the balance of payments.* Any change in one account on the balance of payments is followed by changes in one or more of the others. Tariffs, quotas and trade controls, by reducing the volume and value of merchandise imports will also bring about changes in some of the other accounts. One immediate effect of these barriers is to increase, or preserve, the country's holdings of foreign exchange assets. At the same time, the foreign exchange earnings of the trading partners of protectionist countries are diminished, and some may reduce their imports of merchandise and services as a result. However, if the demand for the protected goods and services is strong and price inelastic, the trading partners might continue to buy them and reduce their imports from other countries instead.

Balance of payments analyses indicate that where a nation's exports decline as a result of trade barriers, the advantages which they confer on protected domestic industries find a counterpart in the reduced sales of the export industries of the protectionist countries. On balance, trade barriers may not be of net advantage to a nation *as a whole*.

Many nations have employed quotas and other controls over trade and exchange to correct balance of payments deficits. Such means of attaining equilibria, in the opinion of many international economists, do not deal with fundamentals. They can be employed as temporary devices but sterner measures are required, these economists point out, if the disequilibria are fundamental. In situations such as those which prevailed during and immediately after World War II, where the belligerents had little to export and were in need of a large volume of imports, these controls were used to good advantage. However, where the disequilibrium is due to domestic causes, involving inflation, industrial and agricultural inefficiency and government fiscal measures, controls will seldom provide a durable cure. In such cases, economic analysis indicates, appropriate domestic measures are required to eliminate the basic causes of the disequilibrium.

*Effects on income* Imports are leakages and exports are injections of purchasing power. Leakages reduce national income while injections increase it. If it were possible to reduce the amount of imports by trade barriers without experiencing a proportionate decline in exports, national income could be increased. The increase would amount to the net excess of exports over imports times the multiplier.

Recent empirical studies point out that while trade restrictions might raise national income, they may also alter its distribution. Since the output and prices of protected industries increase under trade restrictions, the productivity of the factors employed by these industries could rise. Trade restrictions thus are sometimes followed by higher wages, interest, wages of management and profits in the protected industries. On the other hand, the factor returns decline in the export industries adversely affected by the controls. *The net effect upon factor returns as a whole can be computed by equating their increase in protected industries against their decrease in others.*

*Effects on consumers.* Economists have long recognized that trade barriers have an adverse effect upon consumers who pay higher prices and are more limited in their choice of purchases. Consumers may react to these effects by refraining from purchasing protected goods, purchasing smaller amounts, or by selecting substitute goods in their place. Consumers do not constitute a class, everybody is a consumer. In addition to being a consumer, a person may also be a producer. A consumer who is a worker in an industry which profits from trade bar-

riers should balance his gains as a worker against his losses as a consumer. If the consumer is a wage earner in an industry disadvantaged by trade restrictions, he earns less from the reduction in his productivity and pays higher prices for the goods he buys. The net effects of trade barriers on consumers, or more properly on the consumption function of individuals who have other functions, cannot be generalized. They must be analyzed, case by case.

*Effects on the allocation of resources.* It is a generally accepted theory of economics that resource allocation follows price, moving into those uses where prices are higher and out of those where they are lower. Trade barriers tend to alter this market allocation by placing higher prices on the resources devoted to protected industries. According to this theory, this shift in resource allocation is the basic weakness of trade restrictions; they tend to allocate resources to uses where they are not as efficiently employed as they might be in others.

Under complete free trade, economic theory holds, the resources of a nation are employed in those activities where they yield the highest net return and for which the nation has an international comparative advantage. In other words, under free trade, nations import those products for which they are at a comparative disadvantage and pay for them by the export of those for which they have a comparative advantage. By the application of this principle, the law of comparative advantage, resources throughout the world are used at their maximum productivity and consumers, as well as producers, will benefit from such factor utilization. *The diversion of factors from inferior to better applications constitutes the basic reason advanced for the elimination of trade restrictions*

*Trade restrictions and economic development* The argument is often heard that underdeveloped nations cannot develop, or develop rapidly, under a system of free trade. With free trade, so the reasoning goes, the more fully developed economies will dominate those of a lower state of development. Since proposed new industries in the less developed areas face the competition of the well-established enterprises of others, they will never be able to establish themselves without some protection. This reasoning constitutes an application of the infant industries tariff argument.

Tariffs, quotas, import and exchange controls are devices which can be effectively employed to give embryonic industries a fair start, but they are not the only methods available. Assistance in the form of subsidies of various sorts and government contracts are other means of encouraging infant industries and of helping them to survive in the face of strong foreign competitors. These considerations are based upon the

proposition that infant industries cannot develop without protection. Conclusive evidence as to whether or not they can develop without such help is lacking. The weight of evidence at hand, however, seems to indicate that rapid industrial development cannot be obtained without some assistance.

Trade barriers are not the only approaches to the problem of economic development. The following chapter and Part VII of this book are devoted to other and more positive means of attaining these goals.

### QUESTIONS AND PROBLEMS

1. Show graphically and explain the shifting of an import tariff for goods having an inelastic demand, produced under increasing costs and perfect competition.
2. Show graphically and explain the shifting of an import tariff for a monopoly operating under constant costs.
3. Show graphically and explain the shifting of an import tariff for a monopoly operating under increasing costs.
4. Explain the possible effects of an increase in tariffs on an unprotected industry which relies heavily on export markets for its sales.
5. Why did the United States embark on a program of reciprocal tariff reduction during the Great Depression?
6. Does a tariff always provide the protection which its authors hoped that it would? Why or why not?
7. What might the director of a large Swiss watch company have done when the United States denounced the reduction in watch tariffs under the escape clause?
8. Discuss the statement that American export industries bear the principal burden of the United States tariff.
9. If a country refused to license imports of a company's products, and the quantities involved were substantial and therefore important to the firm's future, what might the directors of the company do?
10. Discuss the possible effects of import quotas on domestic industry.
11. How does the tariff improve a nation's terms of trade?
12. Can a nation restore balance of payments disequilibria by import controls? Why or why not?
13. Do import quotas increase the income of a nation which employs them? Explain.
14. Discuss the tariff from the point of view of the theory of comparative advantage.
15. Should the government of an underdeveloped country employ the tariff to obtain greater industrialization? Why or why not? What other alternatives exist?

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## Expansionist Foreign Economic Policies: The Reciprocal Trade Agreements Program

"For the purpose of expanding foreign markets for the products of the United States (as a means of assisting in establishing and maintaining a better relationship among various branches of American agriculture, industry, mining and commerce) by regulating the admission of foreign goods into the United States in accordance with the characteristics and needs of various branches of American production so that foreign markets will be made available to those branches of American production which require and are capable of developing such outlets by affording corresponding market opportunities for foreign products in the United States, the President, whenever he finds as a fact that any existing duties or other import restrictions of the United States or any foreign country are unduly burdening and restricting the foreign trade of the United States and that the purpose above declared will be promoted by the means hereinafter specified, is authorized from time to time . . .

"To enter into foreign trade agreements with foreign governments or instrumentalities thereof; and . . .

"To proclaim such modification of existing duties and other import restrictions, or such additional import restrictions, or such continuance, and for such minimum periods, of existing customs or excise treatment of any article covered by foreign trade agreements, as are required or

appropriate to carry out any foreign trade agreement that the President has entered into hereunder . . .”

This language, quoted from the opening paragraphs of the Hull Reciprocal Trade Agreements Act signed into law on June 12, 1934, announced an about-face in American foreign commercial policy. After some one hundred and seventy years of tariff policies which reflected generally increasing duty rates, the United States started on the path of tariff reductions. The period of restrictive commercial policy came to an end, and this country entered upon a era of expansionist commercial policy.

The United States had been following a tariff policy which appeared to accord to American industry greater tariff protection even as industry became stronger and more capable of facing foreign competition. Such a policy made a mockery of the “infant industry” argument which occupied such an important place in the political tariff debates of the nineteenth century.

The Reciprocal Trade Agreements Act also helped correct a fundamental defect in the tariff-making mechanism. Until the passage of this Act, tariff-making was the perquisite of the legislative power in the United States. Now tariff-making is a highly technical affair. A tariff-maker must be familiar with the technical details of the industries involved. He needs to know costs, pricing policies, distribution channels and marketing methods, among other things, of each affected industry. To supply this necessary information Congress called in representatives of the industries to explain how a tariff for each industry should be elaborated. This procedure not infrequently resulted in criticism of American industry as obtaining much of the protection it wanted without regard for the public interest involved.

Other critics pointed out that Congressional tariff-making was often subject to “log-rolling,” whereby representatives or senators from an industrial area, for example, would vote for the mine protection tariff paragraphs favored by the representatives or senators from a mining area, provided that the latter would in turn support the industry-protecting paragraphs.

The Reciprocal Trade Agreements Act took some of the tariff-making power away from the legislature and placed it in the hands of the executive. The Executive Branch of the government has experts, known as “commodity men,” who are versed in the intricacies of the industries covered by the tariff and are removed from the influence of special interest pleaders. They are thus free to obey the call of the public rather than the regional or industrial interest.

## The Hull Reciprocal Trade Agreements Act of 1934

The Hull Reciprocal Trade Agreements Act of 1934 (RTA), which reversed the trend toward more restrictive trade measures, embodied several provisions to facilitate trade liberalization.<sup>1</sup>

*Authority granted to the Executive Branch.* While unique in a number of ways, the all-important feature of the Reciprocal Trade Agreements Act (RTA) is the authorization granted to the President to negotiate, within broad limits, with other countries for reciprocal tariff and other import barrier reductions. The rate schedules arising from these negotiations are not subject to approval by Congress. Although the President could not under the Act transfer an item from the dutiable list to the free list or vice versa, he was authorized to increase or decrease existing rates by 50 per cent. Since the mid-1940's, however, the President's discretionary powers have been noticeably diluted with the introduction of the escape clause, peril points, and the National Security Amendment. Actually, ever since the inception of the Act, Congress has provided an effective restraint on the Executive Branch by requiring periodic extensions of the RTA. To assure that extensions are forthcoming, the President cannot substantially deviate from a tariff policy acceptable to the Congress.

*Reciprocity.* A second feature of the Reciprocal Trade Agreements Act is that, by virtue of granting the President authority to negotiate tariff reductions, a workable reciprocity provision has been provided. Reciprocity refers to the principle of mutual extension of benefits; that is, one country reduces an import tariff in exchange for a comparable tariff reduction by a second country. The Act of 1934 empowered the President to lower a tariff rate only in exchange for a reciprocal reduction by a second country.

The reciprocity principle, utilized prior to 1934, encountered little success because ratification by the legislatures of the United States and other countries was necessary to legalize the treaty arising from tariff negotiations and legislatures were frequently unwilling to indorse such treaties. The Act of 1934 waived Congressional approval of negotiations and in so doing reciprocity and the procedure of tariff negotiation was expedited.

*Most-favored-nation treatment.* Another aspect of the Reciprocal Trade Agreements Act is that it requires continuation of the unconditional "most-favored-nation treatment" (MFN) which had been in

<sup>1</sup> The Act of 1934, named after Secretary of State Cordell Hull who provided vigorous support for the program, was actually an amendment to the Hawley-Smoot Tariff Act of 1930.

effect since the Tariff Act of 1922. The purpose of *unconditional* MFN treatment is to assure that when a country extends a trade concession to a second country, this concession is generalized, or automatically extended, to all other countries except those which practice discrimination.<sup>2</sup> As an illustration assume that the United States grants a tariff reduction to Great Britain on bicycles; to reciprocate, Great Britain grants a comparable concession, for example, a reduced tariff on her imports of United States refrigerators. With the unconditional MFN treatment a third country, for instance West Germany, which also utilizes unconditional MFN treatment or practices nondiscrimination, can export bicycles to the United States and refrigerators to Great Britain at the new lower rates, whether or not she extends a direct concession to either country. Carrying the example one step further, assume that at a later date West Germany, in negotiation with Denmark, reduces the tariff on imported cheese; by the same token, both the United States and Great Britain, as well as all other nondiscriminating countries, can also export cheese to West Germany at the new reduced rate.

Prior to 1922, United States tariff policy for the most part embodied *conditional* MFN treatment. A concession extended to one country was not automatically granted to third countries unless the latter were willing to make an equivalent concession. Since the conditional MFN policy accorded preferential treatment to some countries, it necessarily discriminated against other exporting areas and thus became a source of antagonism and ill-will toward the commercial behavior of the United States.

Unconditional MFN treatment is generally considered a more suitable method of tariff negotiation primarily because discrimination is avoided. The same tariff rate applies to a product regardless of its origin. It should be noted, however, that in the course of negotiations an importing country bargains directly with the country which is the major supplier of the item being considered. Thus, from the example, the United States granted a tariff reduction to Great Britain on bicycles, and even though the concession was generalized it might be of little or no benefit to many other regions which normally do not export or manufacture bicycles. In other cases, of course, this would not be the case, often a number of countries export a particular item, though in varying quantities. In effect, by utilizing the unconditional MFN treatment, a country avoids future discrimination against its own exports, the procedure is conducive to trade liberalization.

<sup>2</sup> The unconditional MFN treatment applies to virtually all countries except those in the Communist Bloc.

### Subsequent Reciprocal Trade Agreements Legislation

Under the Trade Agreements Act of 1934, the President was empowered to reduce tariff rates by 50 per cent. In 1945 he was further authorized to cut duties to one-half of the then existing level. Legislation subsequent to 1955 emphasized the desire for a gradual lowering of tariffs; the 1955 extension sanctioned a non-cumulative 5 per cent reduction of existing rates for each of the three following years.

A four-year extension granted by Congress in 1958 provides the Executive Branch with three alternative approaches to the reduction of tariffs. First, a 20 per cent reduction in import duties existing as of July 1, 1958, is permitted. Generally, only one-half of the total reduction is allowed during any one year. Second, the extension grants the President the authority to reduce tariff rates existing on July 1, 1958 by two percentage points. Normally one-half of the total reduction is the maximum permitted in any one year. This approach is more effective in lowering barriers than the first alternative only in instances where the existing ad valorem rate is less than 10 per cent. Finally, under a third alternative, existing ad valorem rates in excess of 50 per cent can be reduced to 50 per cent. This alternative is more useful than the first in instances where the existing ad valorem rate is in excess of 62 per cent. Again, emphasis is placed on gradual liberalization of trade barriers, one-third of the total authorized reduction is the maximum permitted during any one year.

In addition to the authority to lower existing trade barriers, the President is empowered by the 1958 extension to increase existing tariff rates. With respect to revising tariff rates, it appears that the role of the Executive Branch has not been weakened since 1934. However, other modifications of the Trade Agreements Program, notably the escape clause, the peril point provisions, and the National Security Amendment have tended to restrain the tariff actions of the President.

*Escape Clause.* Congress seemingly regretted its outburst of generosity in 1934, and in subsequent legislation tended to curb Presidential power. From the inception of the Act, Congress has closely guarded its delegated authority by insisting upon periodic renewals of the RTA. Stemming largely from its fear of jeopardizing negotiation powers, the Executive Branch agreed as early as 1943 to insert an escape clause in all future trade agreements. Subsequently the use of the escape clause was prescribed by an executive order and finally was incorporated as a statutory provision of the Trade Agreements Act in 1951.

Under the escape clause, either party to a trade agreement, in view of actual or threatened serious injury to domestic industries arising

from imports, can discontinue or modify a previously-granted concession. Obviously it is difficult to make a conclusive determination of what constitutes serious injury to domestic industries as a result of a concession. In practice, the United States Tariff Commission, upon investigation of a complaint alleging injury, evaluates the impact of the imports on the affected industry, taking into consideration production, employment, prices, and wages, among other things. The Tariff Commission then makes a recommendation to the President for modification, withdrawal, or other change in the previously-granted concession. The President renders the final decision, but should he reject a recommendation of the Commission to invoke the escape clause he must explain his action to Congress. The President's decision can be reversed by a two-thirds vote of Congress.

Many foreign countries have been critical of the escape clause because it injects an element of uncertainty into the United States Trade Agreements Program. Foreign exporters complain that considerable effort and expense are required to enter the American markets. If a foreign firm, after extensive promotion and investment, is successfully competing in the United States market it runs the risk that this may be construed as a threat of serious injury to domestic producers. Consequently, the President may feel compelled to invoke the escape clause and restore the tariff to the original level or even establish more restrictive import quotas. Domestic firms which depend extensively upon imported materials are placed in an equally insecure position.

Although uncertainty of this nature is not compatible with trade expansion, it must be recognized that the escape clause has not been frequently used. As shown in Table 22.1 the Tariff Commission as well as successive Presidents have been reluctant to invoke the escape clause. One might argue that the inclusion of an escape clause actually

expedites the original tariff negotiations. A country, recognizing that the impact of a larger volume of imports cannot be predicted, may be willing to yield certain concessions on the condition that such concessions may be withdrawn at a later date if damage to domestic industry becomes severe.

*Peril points.* A further reduction of the discretionary action afforded the President is caused by the "peril point" clause which has been incorporated into most Trade Agreements Acts since 1948. The peril point clause prescribes that the Tariff Commission investigate the possible impact of tariff reductions proposed by the President. From its findings the Commission estimates minimum tariff rates or peril points which can be established on the commodities without inflicting serious damage on domestic industries. If the President reduces tariffs below the recommended minimum, he must explain the reason for his action to Congress.

*National Security Amendment.* A further provision incorporated into the Trade Agreements Act of 1954 specified that the President shall not lower tariffs on imported items which will threaten domestic industries essential for national defense. Subsequent modification affords the President more power relative to a possible impairment of national security, but the additional power is in terms of additional trade restriction. Acting on the advice of the Director of the Office of Civilian and Defense Mobilization, the President might conceivably assume an extreme position and impose a complete embargo on imports which he considers to be adverse to the interests of national defense.

The national security argument appears beyond reproach, on the surface at least. If increased imports jeopardize national security, then tariffs should be raised. However, a deeper probe of this provision reveals some serious questions. For example, what is the relationship between tariff policy and national security? Would complete self-sufficiency provide maximum national security? Perhaps a liberal trade policy on the part of the United States would be a favorable element in the cause of defense. In addition, a high level of trade is needed to strengthen the economies of allied nations. Too, what domestic industries are not vital in the event of conflict? In its extreme form the national security argument could imply a complete embargo of all imports, with the exception of a few types of raw materials which cannot be produced domestically.<sup>3</sup>

<sup>3</sup> During 1958 and 1959 domestic industries petitioned, under the National Security Amendment, for restrictions on such imports as steam turbine generators, cobalt, tungsten, surplus military rifles, dental burrs and wool knit gloves

*Effects of subsequent amendments.* Although the United States tariff policy has tended to remain liberal since 1934, a concurrent trend toward a restriction of Presidential authority has been noticeable. A lack of certainty also characterizes American tariff policy. As a result some foreign firms are discouraged from entering our markets because of the possibility of more severe barriers in the future. Furthermore, the required periodic renewals of trade agreements legislation, the escape clause, peril points, and the National Security Amendment tend to conflict with the avowed purpose of the Act—the expansion of United States trade. Actually, of course, some of the modifications of the original Trade Agreements Act represent legislative compromises to assure preservation of the major features of the Act. It is important that these major features of the tariff program be retained because the commercial policy of the United States influences the economies of foreign nations.

*The Trade Agreements Program and bilateral negotiations.* The Trade Agreements Program, which represents the cornerstone of United States commercial policy, broadened the possibilities of success in tariff negotiation with foreign countries. As shown in Table 22.2, under the Reciprocal Trade Agreements Act the United States government was able to conclude many bilateral agreements with foreign countries. Until the inception of the General Agreement on Tariffs and Trade in 1947, tariff negotiations were conducted bilaterally with individual foreign countries. As pointed out later, multilateral negotiation, which was provided by the General Agreement, proved to be a superior method of obtaining tariff concessions throughout the world. This arrangement (examined in a later part of the present chapter) accommodates the combined negotiations of forty countries. The essential problem with bilateral negotiation was that countries attempted to save their bargaining power for dealings with other countries at a later date.

### The Invisible Tariff and Customs Simplification

The customs tariff is but one of several obstacles which importers of foreign goods into the United States must meet. As the Executive Branch sought to reduce tariffs through the application of the Reciprocal Trade Agreements Acts, the complexity of customs regulations, tariff rates, procedures, classifications, and valuations became increasingly apparent. These regulations constitute a sort of "invisible tariff" which effectively serve to confound exporters and importers alike, and to impede the importation of goods into the United States.

*Complexity of regulations* The customs regulations of the United States constitute one of the principal legal impediments to the importation of goods. These same regulations have long constituted an impediment

TABLE 22.2

BILATERAL TRADE AGREEMENTS IN FORCE OR SUPERCEDED  
BY MULTILATERAL AGREEMENTS

Country	Date Effective
Argentina (B)	Nov. 15, 1941
Belgium (M)	Jan. 1, 1948
Brazil (M)	July 31, 1948
Canada (M)	Jan. 1, 1948
Cuba (M)	Jan. 1, 1948
El Salvador (B)	May 31, 1937
Finland (M)	May 25, 1950
France (M)	Jan. 1, 1948
Haiti (M)	Jan. 1, 1950
Honduras (B)	Mar. 2, 1936
Iceland (B)	Nov. 19, 1943
Luxembourg (M)	Jan. 1, 1948
Netherlands (M)	Jan. 1, 1948
Nicaragua (M)	May 28, 1950
Paraguay (B)	Apr. 9, 1947
Peru (M)	Oct. 7, 1951
Sweden (M)	Apr. 30, 1950
Switzerland (B)	Feb. 15, 1936
Turkey (M)	Oct. 17, 1951
United Kingdom (M)	Jan. 1, 1948
Uruguay (M)	Dec. 16, 1953
Venezuela (B)	Dec. 16, 1939

Note. (B) indicates the countries with which the United States has bilateral agreements that are still in force. (M) indicates that a bilateral agreement was terminated because the country became a party to a multilateral agreement (General Agreement on Tariffs and Trade). The United States has also had bilateral trade agreements, but which have been terminated, with Colombia, Costa Rica, Czechoslovakia, Ecuador, Guatemala, Iran and Mexico.

Source "United States Trade Agreements Concluded Since 1934 Reviewed," *Foreign Commerce Weekly* U.S. Department of Commerce, Washington, D.C. Vol. 65, No. 23, June 5, 1961 P. 36.

ment to trade on the part of American importers and a prime discouragement to foreign exporters to this country. In the *Custom House Guide* for 1955, published by the Custom House Guide of New York, the customs regulations of the United States occupy 531 pages of fine print, pages 1101 to 1632. The following quotation from the customs regulations of the United States from article 498 (g), (1), (2) and (2i), relating to the fees collected from ship-owners according to the length of the ship's manifest, will give some idea of what foreign shippers encounter:

"(1) The word 'folio' shall mean 100 words, counting each figure as a word (44 U.S.C. 326). No charge shall be made for fractions of a folio.

"(2) When any instrument presented is not on an appropriate customs form, the number of folios shall be computed under the pertinent one of the following formulas.

"(i) Except as specified in subdivision (m) of this paragraph, if the instrument is of less than 20 pages, the total number of lines shall be determined; the number of words in 10 per cent of the lines of each size and style of writing or printing (handwritten, pica typewritten, elite typewritten, printed, etc., full measure, indented, etc.) shall be counted, using lines of average length, the average number of words per line of each size and style of writing or printing shall be multiplied by the total number of lines of each size and style in order to arrive at the total number of words; and the total shall be divided by 100 in order to ascertain the total number of folios."

*Commodity classification.* A further barrier to importation is introduced by the complexity of product classification. Rather than a relatively small number of commodity classifications for tariff purposes, the system is characterized by thousands of minute divisions and subdivisions. Procedures become even more complicated as new types of products enter the country and an attempt is made to group them on the basis of a system established years ago. Because of the wide range of tariff rates relevant to different imports, the classification assigned to a product is crucial. Frequently it determines whether or not an item can be profitably exported to the United States. Not only are the applicable rates sometimes unpredictable, but also the classification may involve a considerable delay for the importer.

*Import valuation.* One of the most cumbersome of the procedural barriers in the past was the dual valuation required of imports subject to ad valorem duties. A valuation was required in terms of the wholesale price at which an article is exported to the United States, and the price at which the product is marketed in the country of origin. The dual valuation, which was necessary since the ad valorem rate applied to the higher of the two values, served to create considerable delay and uncertainty in determination of the total import duty. However, the problem of dual valuation was partially solved by the Customs Simplification Acts.

*Import procedure.* Typically, as goods enter this country, customs officials exact a payment from the importer in an amount equivalent to the estimated import duty, most goods are then released to the importer. Following this, customs officials may undertake a more thorough investigation, including the determination of the value of the product, its proper classification and the applicable tariff rate. The final duty is then determined (in some cases after the lapse of several months) and the difference, if any, is demanded from the importer.

This normally terminates the process, unless (a) the importer insists that either the classification or the duty rate on the product is untenable or (b) competing domestic firms complain that the effective duty is too low. If either of the grieved parties lodges a complaint, the

case may be forced into litigation in the Customs Court, a procedure which tends to be lengthy. Eventually most cases are settled in the Customs Court, but occasionally they are appealed to a higher court. Obviously, the prolongation and incertitude tend to discourage an increased flow of imports.

*Customs simplification.* From the foregoing, it is apparent that the different legal impediments serve to discourage importation. Although administrative procedures remain cumbersome, substantial progress was made toward streamlining administrative technicalities through the Customs Simplification Acts of 1953, 1954, and 1956. As an illustration, notable advancement was reached with the elimination of the dual valuation for certain ad valorem rates.<sup>4</sup> Additionally, accounting procedures have been simplified and burdensome restrictions relative to marks of origin have been relaxed.

Customs simplification is an intricate task. Some administrative simplification has been achieved independently by customs officials. For the most part, however, further easing of the invisible tariff will require legislative action. For example, a broadening of commodity classifications, which would eliminate many complexities, will probably require Congressional approval because of the variety of applicable duties. If import duties are altered as a result of such changes, this might also require negotiation with exporting countries.

*Sanitary regulations.* An important type of the invisible tariff takes the form of sanitary regulations designed to prevent the importation of impure foods and drugs, and infected plants and animals.<sup>5</sup> While the original intent of these regulations—protection of the American consumer—is desirable, foreign producers frequently complain that the administration of the regulations is so severe that it has additionally become a device for excluding the importation of food, drugs, plants and animals.

It is difficult for the government to counter these charges. In the first place, even though the intent of the laws may be perfectly clear it may be impossible in many instances to determine if actual administration serves to do something other than protect consumer interests. Second, foreign exporters frequently overlook or are unaware of the fact that internal sanitary regulations also apply to American firms which sell these items in the domestic markets.

<sup>4</sup> It should be noted that the use of specific as opposed to ad valorem duties precludes the need for commodity valuation.

<sup>5</sup> Sanitary regulations administered by the Food and Drug Administration and the Department of Agriculture are embodied in a number of acts, including the Plant and Quarantine Act, the Federal Seed Act, and the Food, Drug, and Cosmetic Act.

*Buy American legislation.* Another form of import restriction was imposed by the Buy American Act of 1933.<sup>6</sup> This Act stipulates that all goods purchased for public use must originate from domestic sources. Exceptions are permitted if the domestic cost is unreasonable or the purchase is inconsistent with the public interest.

As interpreted for many years, a foreign exporter would normally be awarded a government contract only if the lowest price quoted by domestic firms exceeded the import price, including duty, by more than 25 per cent. Since 1954, the 25 per cent differential has been reduced to between 6 and 10 per cent. An exception is provided if the items to be purchased are produced in domestic areas characterized by substantial unemployment. In view of the aggregate volume of spending by federal, state and local governments, the amount of imports excluded by this type of legislation is substantial.

### The International Trade Organization

As the United States applied the principles of the Reciprocal Trade Agreements Acts, it came to recognize that success in liberalization of international trade would require the understanding and cooperation of foreign countries. To secure these ends the United States assumed the initiative in assembling representatives of the major trading countries in 1947 and 1948 to formulate a "rule book" for international trade. This assembly drafted a set of rules which were to be embodied in the Charter for an International Trade Organization (ITO).

*Objectives of the ITO.* The major objective of the proposed ITO was the establishment of a code of commercial behavior whereby international trade might flourish on a multilateral basis unobstructed by restrictions and other controls, except under special circumstances. The Charter for the ITO expressed the desire for a gradual reduction of tariffs, and opposed the use of import quotas, import licenses, and export subsidies. At the same time the Charter condoned certain deviations from these rules. escape clauses were to be incorporated into trade agreements so that concessions could be modified if injury resulted to domestic producers, various forms of import restrictions could be employed to protect infant industries, to counter a decline in monetary reserves and to enable countries to continue their assistance to domestic agricultural and raw material producers.

*Fate of the ITO.* Although the Charter for the ITO was sponsored by the United States Executive Branch, Congress failed to ratify it.

<sup>6</sup> The Buy American legislation was an amendment to the Treasury and Post Office Department Appropriation Act of 1933. In addition to the federal act, many of the states have Buy American Acts of their own.

Inability to attract widespread domestic support for the Charter was due to a combination of reasons. The Charter, although it espoused relatively liberal objectives, condoned a series of exceptions and escape clauses which rendered the general objectives almost meaningless. While it reflected the desire for unobstructed international trade, so many exceptions were provided that as a whole the Charter had little to offer as a guide to international commercial behavior. In an extensive effort to appeal to both domestic and foreign interests, the final document satisfied few domestic groups. Since United States participation was necessary if ITO was to have any value, virtually all other countries accordingly failed to approve the Charter.

The collapse of the ITO was a setback in the field of world-wide foreign trade planning. This organization, the International Monetary Fund and the International Bank for Reconstruction and Development were to represent a triad of institutions with operations in the areas of international trade, payments and investment. Fortunately, the Fund and the World Bank did come into existence, and many of the principles included in the Charter for an ITO were embodied in the General Agreement on Tariffs and Trade.

### The General Agreement on Tariffs and Trade

At the same time that negotiations were being conducted for an International Trade Organization in 1947, a meeting of the representatives of twenty-three nations was conducted in Geneva to negotiate tariff reductions and to formulate temporary rules of international commercial behavior. It was assumed that the results of the Geneva conference, the General Agreement on Tariffs and Trade (GATT), would be incorporated into the ITO Charter. While the ITO is today but a reminder of failure at international cooperation, GATT has survived to become the most comprehensive endeavor that has ever been adopted by governments for world trade liberalization. Essentially, GATT consists of three major parts, schedules of tariff concessions, a set of rules, and an organization for administrative purposes.

*Schedules of tariff concessions.* The schedules of tariff concessions, one for each member or contracting party, show the tariff rates which each country is committed to extend to all others for every listed product.<sup>1</sup> The specified rates may constitute a reduction, a rate less than that applicable at the beginning of the negotiation, or they may constitute a "binding," an agreement to prevent a future increase or decrease

<sup>1</sup> "Contracting parties" (lower case letters) refers to individual member countries of GATT; "CONTRACTING PARTIES" (upper case letters) refers to member countries acting jointly, or as an organization.

in a rate. These concessions have been secured in the course of several negotiating conferences which were conducted in 1947 and the years following. The first session in 1947 produced approximately 45,000 concessions, reductions or bindings, in tariff rates. In subsequent sessions, the number has grown to over 60,000.

*Set of rules* A second integral part of the General Agreement consists of a set of rules or code of behavior to guide member countries in commercial policy. This code not only lists the general provisions for commercial policy, but also prescribes certain conditions under which deviations may occur. A major principle incorporated into GATT is the unconditional most-favored-nation treatment; a concession extended by one country automatically applies to all other contracting parties. The General Agreement prohibits the use of quantitative arrangements, subject to certain exceptions. Exchange controls are not to be utilized for the purpose of restricting trade and the use of export subsidies is discouraged.

Although these general rules represent an important part of the General Agreement, the exceptions to the over-all rules which may be invoked under special circumstances are equally significant. One important exception is the use of restrictions in instances where countries are experiencing balance of payments disequilibria. When a country's foreign exchange reserves are declining seriously, or are already relatively low, import restrictions are sanctioned by GATT.

The General Agreement also contains an escape clause, which permits the withdrawal or modification of a concession if increased imports cause or threaten serious injury to domestic producers. GATT also allows quantitative restrictions to be employed by underdeveloped countries for the protection of infant industries. Export subsidies may be utilized under specified circumstances. Finally, GATT authorizes the use of import quotas to permit the continuation of governmental assistance programs to domestic agricultural sectors.

It might appear from the foregoing that, because of the exceptions permitted by GATT for the use of import restrictions, this organization would have little value in inducing trade liberalization. Actually, the escape clause and import restrictions condoned by GATT cannot be easily and independently invoked, and considerable moral and economic pressure is exerted upon countries to avoid over-using them. Thus in order to invoke the escape clause a country must notify and secure approval of the country or countries which might be affected. If the latter disapprove of the action of the first country, they retain the right to make adjustments in their own concessions.

Those countries continuing to utilize exchange controls and other

restrictions for balance of payments purposes must consult periodically with GATT to justify such action. If GATT determines that restrictions are no longer needed, it can recommend that they be removed. While the country in question need not comply with the recommendation, other injured countries are subsequently permitted to apply compensatory measures.

Those underdeveloped countries desiring to employ quantitative restrictions to protect infant industries must seek an acceptable arrangement with the countries affected and obtain approval from the CONTRACTING PARTIES. Provisions for the use of export subsidies are somewhat vague. Generally when the effect is to create serious injury to the other members, the granting country must submit an explanation to the CONTRACTING PARTIES. This may result in a request to modify the subsidization. Import quotas can be imposed on agricultural commodities on the condition that a country also institute domestic production control for such commodities.

In addition to the possible direct economic repercussions resulting from the application of the escape clause, export subsidies, and quantitative restrictions, further pressure can be exerted on countries because of the fact that GATT serves as a forum through which grievances are aired in the presence of a world-wide audience. This has probably been a significant factor in influencing the general willingness of contracting parties toward acceptance of the spirit of the General Agreement. Finally, the disposition of countries to avert a trend toward retaliatory import barriers induces them to comply with the principles of GATT.

*Administrative organization* Because it was expected that GATT would be incorporated into the International Trade Organization, there was no effort originally to provide a formal administrative organization. Since the ITO failed to materialize, substitute arrangements were devised. GATT is an organization in the sense that it provides for joint action by member countries or CONTRACTING PARTIES. As an organization, member countries jointly perform a variety of administrative functions, assist in settlement of trade disputes, prescribe compensatory action granted an injured party to a trade dispute, and render decisions on interpretive matters. Each country is entitled to one vote, and normally decisions are based on majority rule.

*Multilateral negotiation under GATT.* The key to much of GATT's success is that in practice, it enables multilateral trade liberalization negotiation. Prior to the formation of GATT, the United States conducted bilateral negotiations with individual foreign countries. Bilateral negotiations were not conducive to rapid liberalization. In many in-

stances, as a tariff was reduced, the definition or classification of the product would be specified as narrowly as possible in an attempt by one country to limit the concession made to a second country. In this manner the first country would conserve its bargaining power for negotiations with other potential exporters of virtually the same types of products. Essentially, this represented an attempt by a country to remain eligible for unconditional MFN treatment from other countries while practicing conditional MFN treatment itself.

During the sessions of GATT, negotiations are initiated on a bilateral basis; each contracting party desiring to extend concessions meets with the major exporting country of every item under consideration. Although the initial bilateral bargaining is conditional, each country recognizes that virtually all countries which might benefit from negotiations are represented and is therefore not impelled to save its bargaining power. Accordingly, participants are more willing to make mutual, reciprocating concessions. As the negotiations near completion many bilateral agreements are adopted, but with the unconditional MFN provision all bilateral concessions are extended multilaterally to all other participants.

Each particular participant receives not only the concessions it has bargained for directly, but also the indirect benefits from the simultaneous negotiations of other bilateral agreements as the unconditional MFN treatment is implemented. The simultaneous bargaining of many pairs of negotiating teams is conducive to reduced trade restrictions since each contracting party is aware of the benefits it is receiving from the other nations prior to the consummation of the entire agreement.

*The success of GATT.* Many advocates of trade liberalization express the feeling that GATT has been useful as a medium for the promotion of a freer movement of international trade. It is, of course, impossible to indicate specifically how successful GATT has been. The fact, however, that over 60,000 concessions have been granted attests to the progress which has been made toward trade liberalization since its inception. In 1947, there were twenty-three member countries; by 1962 a total of forty countries, including all the major countries except the U.S.S.R. and some of its satellites, were participating. In the aggregate, the contracting parties account for more than three-fourths of total world trade.

In addition to providing an instrument for tariff reduction, GATT has been successful in the settlement of international trade disputes. By providing a public forum for airing of grievances and by making recommendations for their settlement, GATT has been able to resolve a number of disagreements which otherwise might have produced con-

flict. In no instance is a member country forced to accept the recommendations of the CONTRACTING PARTIES. However, besides being subjected to diplomatic pressures, a country which violates the principles of GATT is subjected to economic pressures as injured parties withdraw concessions which were granted previously. A growing respect for GATT has often induced the bilateral settlement of disputes before they reach that agency.

On the negative side, the success of GATT in the elimination of quantitative trade barriers has been more limited than anticipated. Many member countries maintained quantitative restrictions for balance of payments purposes much longer than was anticipated, and some members still employ these controls. This situation is unfortunate because it was originally expected that multilateral rather than bilateral negotiations would be instrumental in the removal of quantitative controls. GATT itself has neither the authority nor the financial capacity to correct disturbances which create the need for quantitative restrictions.

Another problem has been the necessity of granting the United States a waiver for the use of quotas on agricultural imports. Under the circumstances, the imposition of quotas was clearly a violation of the principles of GATT. At the same time GATT would be of little value without the participation of the United States. Accordingly, the United States was reluctantly granted the waiver by other contracting parties.

In summary, GATT has probably been an important factor in the growth in international trade in the post-war period. The association of such a large number of countries with a world-wide organization embodying relatively liberal rules of commercial behavior is an accomplishment in itself. This cooperation is in sharp contrast to the economic nationalism which characterized the period between the two World Wars.

### Organization for Trade Cooperation

GATT itself is essentially a written agreement and as yet has no formal organization. Because certain basic questions arise with respect to organizational and administrative problems which tend to hamper the operation of GATT, the creation of a more formal and permanent administrative agency, the Organization for Trade Cooperation (OTC), has been urged by various GATT members.

*Proposed functions for the OTC.* The duties of the Organization for Trade Cooperation, primarily administrative in nature, would complement GATT and thus render the whole procedure of negotiation more effective. The need for a permanent organization became pressing

with the advent of negotiations with the European Economic Community and the European Free Trade Association.

The proposed OTC would be divided into three major parts: an assembly, an executive committee, and a secretariat. The assembly, which would provide the ultimate source of authority for the OTC, would include all GATT members and would convene annually. The executive committee, composed of a number of members of the GATT selected by the assembly, would undertake a variety of duties assigned by the assembly. The secretariat would perform such functions as the arrangement and sponsorship of negotiations, the supervision and publication of studies, reports and statistics and the execution of other administrative details as determined by the assembly.

*Implementation of the OTC.* The proposed OTC will come into existence as soon as it is ratified by a sufficient number of contracting parties. This number must comprise 85 per cent of the external trade of the parties. Since the United States accounts for more than 15 per cent of the world's external trade, Congressional ratification is necessary before the OTC can commence operation.

The fact that the OTC still awaits Congressional acceptance represents a victory for the protectionist element in the United States. Legislative approval of membership in GATT has not been required. The Executive Branch assumed the right to participate by virtue of the broad powers granted under the Constitution to conduct foreign affairs and the authority received under the Trade Agreements Program. At the same time, Congress asserts in the RTA that "the enactment of this Act shall not be construed to determine or indicate the approval or disapproval by the Congress" of GATT. Membership in the OTC does require legislative approval which has not as yet been obtained.

*The United States and tariff policy.* The United States is the major trading nation in the world, and its commercial policy has a significant impact upon the well-being of economics throughout the world. American policy also exerts considerable influence upon the conduct of other governments in their external affairs. In a democracy the enactment of tariff legislation is fraught with difficulties arising from conflicting domestic interests. The United States and the rest of the world are far from achieving a relatively free movement of resources, goods and services, but noteworthy progress has been made in this direction. Two of the more significant events promoting the liberalization of international trade have been the enactment of the United States Reciprocal Trade Agreements Program and the creation of the General Agreement on Tariffs and Trade. However, it is believed that certain modifications are required if the RTA is to be effectively used by the President for trade

liberalization. For one thing, power to lower tariffs across the board rather than the item by item approach, would facilitate negotiations with the European Economic Community. Establishment of the OTC would also facilitate efforts toward unrestricted world trade.

### QUESTIONS AND PROBLEMS

1. What is meant by the "invisible tariff?" List some examples of this type of import restriction.
2. What is the purpose of (a) the escape clause, (b) peril points, and (c) the National Security Amendment?
3. Each time the Trade Agreements Program comes up for renewal it appears to face increasing Congressional opposition. What might be some of the consequences if tariff making were to revert to Congress?
4. Foreign exporters frequently complain of the uncertainty which characterizes United States tariff and commercial policy. Describe features of United States policy which contribute to this uncertainty.
5. Describe the major features of the General Agreement on Tariffs and Trade.
6. "The General Agreement on Tariffs and Trade has been a relatively successful arrangement for liberalization of world trade." Comment on this statement.
7. What are the advantages of multilateral negotiation for tariff reductions as opposed to bilateral negotiations?
8. How would the proposed Organization for Trade Cooperation assist in the process of trade liberalization?
9. "The Buy American Act serves to help maintain domestic wages and to protect the American standard of living." Comment on this opinion.
10. As the world's foremost trader, the United States would gain from freer trade. Why, then, doesn't the United States initiate a more vigorous effort to liberalize trade?

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## The Development of Underdeveloped Areas

"It is the sense of the Congress that peace depends on wider recognition of the dignity and interdependence of men . . .

"To this end, the United States has in the past provided assistance to help strengthen the forces of freedom by aiding peoples of less developed friendly countries of the world to develop their resources and improve their living standards, to realize their aspirations for justice, education, dignity, and respect as individual human beings. . ."<sup>1</sup>

As this passage from the International Development Act of 1961 indicates, Congress has affirmed its intention of continuing programs of aid to underdeveloped countries. These programs have met an important need. As shown in Table 23.1, differences in economic conditions throughout the world are extreme.<sup>2</sup> Unfortunately there is neither a simple explanation nor a ready solution for the problems of economic stagnation which grips populations in their struggle for survival. Economic growth is a complicated process. It embodies political, social and psychological elements.

<sup>1</sup> Section 102, Part I (Act for International Development of 1961) Public Law 87-195, 87th Congress

<sup>2</sup> Because the data are estimates, caution must be used in the comparison of per capita incomes of different countries.

TABLE 23.1

ESTIMATED PER CAPITA GROSS NATIONAL PRODUCT BY REGION 1959

Region	GNP per capita (dollars)
Western Europe	838
Africa	125
Near East	188
South Asia	72
Far East	167
Oceania	1,200
Latin America	285
Continental United States	2,722
Canada	1,983

Source: Office of Statistics and Reports, International Cooperation Administration, April 10, 1961.

### Nature and Scope of the Problem

A growing awareness of their relative poverty has stirred the people in the underdeveloped areas to an impatient clamor for material improvement. The desire of many countries is for greater economic development.

*Definitions of underdevelopment.* By a simple definition, countries are classified as "underdeveloped" if the per capita income of their inhabitants is low, relative to other countries. A more extended definition suggests that although underdeveloped countries presently have relatively low incomes, they do contain potential natural or human resources for a marked increase in income. Such resources are not being fully or efficiently utilized but await the introduction of complementary resources or structural changes within the productive system. By either of these definitions, most of the countries of Asia, Africa and Latin America are underdeveloped.

Economic development is not usually prized as an end in itself. It is rather a means of procuring other objectives. Development and the corresponding higher real incomes are factors necessary to implement the attainment of other goals which vary not only among countries but also among individuals. At the same time, this development is not desired to the exclusion of other prerogatives, such as civil liberties, political freedom and national security.

*Description of underdeveloped areas.* Although the underdeveloped countries differ considerably and hence preclude complete generalizations, they do exhibit a number of similar features. By definition, one of the common traits of the underdeveloped areas is that per capita incomes are relatively low. Their poor economic status is reflected in

other standards, including low calorie diets, literacy rates and life expectancy. In addition, and not unlike the advanced countries, wide extremes of income exist within each country.

Another characteristic is that the underdeveloped countries are predominantly primary-goods producers, with agriculture, mining and petroleum representing the major industries. Agriculture is a particularly important industry, commonly employing from one-half to two-thirds or more of the labor force. However, even with this high degree of specialization there is a minimum use of modern farming methods, and frequently the farmer is barely able to eke out an existence for himself and his immediate family. In many countries, especially in Asia and parts of Africa, this sector contains "disguised unemployment" or "underemployment;" the marginal productivity of labor is very low, zero, or perhaps even negative. In other words, some of the workers could be removed to other types of employment without a decline in total agricultural output.

An additional characteristic closely related to the foregoing is the dependence on one or two types of export items, usually raw materials or foodstuffs, as the source of foreign exchange earnings. For example, over 60 per cent of the aggregate value of Bolivia's exports is comprised of tin; petroleum accounts for over 90 per cent of the value of Iraq's and Venezuela's exports; for Brazil, Colombia, El Salvador, Ethiopia, Guatemala and Haiti, coffee constitutes from one-half to over three-fourths of all export values. Furthermore, most underdeveloped countries are foreign trade oriented and exhibit a high ratio of exports to national product. The high foreign trade ratio of the underdeveloped countries is not an indication of the benefits of specialization and international exchange; it is an indication of the fact that national product is relatively low.<sup>3</sup>

Other traits typical of most underdeveloped countries are a high birth rate and in recent years a declining death rate. This combination has created severe population pressures. The situation is in contrast to the advanced countries, where medical progress and reduced mortality rates accompanied or followed economic improvement and increased productivity. In the underdeveloped countries, the lower death rates have preceded economic advancement. As a result the growing populations have often become a burden.

Most of the underdeveloped countries lie within the tropical or subtropical belts, a factor of some importance in the quest for material

<sup>3</sup> Myrdal, Gunnar. *An International Economy*. New York: Harper and Brothers Publishers, 1956, pp. 225-228.

advancement because a tropical climate is not conducive to maximum physical effort. Peak labor efficiency is more readily attained in drier and cooler climates.

The underdeveloped countries as a whole play critical roles in the economic and political activity of the world. These areas are important economically to the more advanced countries as sources of petroleum, tropical foodstuffs such as bananas, cocoa, coffee and sugar and certain strategic materials, such as cobalt, manganese, tin and industrial diamonds. They are equally important as markets for consumer goods and producers' equipment produced by the advanced countries. Politically, most of these countries are either neutrals or are not strongly committed to either the East or West. A movement in either direction could result in a decisive shift in the international balance of power.

Although the underdeveloped countries are similar in these respects, some diversity is evident. A combination of factors underlies the varying degrees of basic preparation for economic growth among the different countries.<sup>4</sup> Economic advancement is more of a reality for those which have undergone a favorable evolution in social environment, have undertaken initial steps in developmental planning, and are aware of the additional requirements. Others possess very primitive cultures and institutions and meager natural resources. For the latter the outlook for development is bleak.

### Obstacles to Economic Development

The transformation of the economies of these areas to facilitate higher standards of living is a complicated process. Inherent within the aggregate social, economic and political complexion of the poor countries are a series of obstacles which render the transition to modernization a discouraging endeavor. The extent to which any of the particular characteristics impede development depends upon the country in question. For some countries, the major obstacles—political instability, population pressures, low volume of savings, foreign exchange shortage, and influences of the past—appear almost insurmountable.

*Political instability* One of the important single obstructions to

<sup>4</sup> The Center for International Studies, Massachusetts Institute of Technology, identifies three categories of underdeveloped nations. This classification is largely based on the degree of development of social overhead capital. See Center for International Studies "Economic, Social, and Political Change in the Underdeveloped Countries and its Implications for United States Policy," *United States Foreign Policy*, Massachusetts Institute of Technology. Printed for the use of the Committee on Foreign Relations, United States Senate, Washington, D. C., March, 1960.

economic advancement is the political instability which frequently prevails in these areas. Many of the underdeveloped countries, especially in Africa, have only recently been freed from colonial domination, and they have not yet established strong and mature central administrations. A number of them are undergoing political transformation, and the demand for self-determination has taken precedence over other objectives. Still others, although they have been independent nations for generations, remain unable to organize a government with sufficient permanence and authority to be conducive to economic advancement.

A stable government is essential if the economy is to have a healthy producing sector. If under the existing system the government is to be an active producer it must be endowed with capacity to command and direct resources in a suitable fashion. If, under a contrary system, public-owned enterprise is opposed the government must still possess the ability to provide a favorable framework for private enterprise.

An unstable government also tends to deter the inflow of external capital. Foreign investors are acutely conscious of the risk involved in ventures in other lands, especially when this risk is intensified by threats of expropriation; civil strife or invasion from external areas. Occasionally, nationalistic tendencies and prejudices repel the inflow of capital and entrepreneurial ability. In a similar manner, a stable political atmosphere is needed to discourage "capital flights"—outflows of capital not motivated by higher returns elsewhere. Another factor which necessitates political integration is that economic development plans are essentially long-run in nature and can be best programmed by a central administration with relatively consistent attitudes and methods.

In these and other ways a government exerts influence on economic activity both within and without its political boundaries. Although a quiet political climate is probably a prerequisite for economic development, the opposite causal relationship may be true: Economic well-being of the masses may be essential in order to attain political maturity. Hence, economic and political factors are closely related, and the alleviation of one problem may serve in part at least to solve the other.

*Population pressures.* A second obstacle to economic advancement is population density—the high ratio of people to available resources. Population pressure, the outgrowth of a high birth rate and in recent years a declining death rate, is particularly significant in Asia and much of Africa. Modern science and medicine have made spectacular progress in contracting the mortality rate. Frequently the prevention of disease has taken a simple and inexpensive form, for example, the use of D.D.T. to reduce the threat of malaria and other diseases. Generally, the rate

of population growth is substantially higher in the underdeveloped regions than in the more advanced countries.<sup>5</sup>

A large population can be interpreted as a problem only when related to natural resources, technological developments and capital. Although population density is higher in both Great Britain and the Netherlands, for example, than in most of the underdeveloped regions, it is generally not considered a major problem in these two countries. The difficulty in the poor countries is that population has continued to expand without a comparable expansion in production of foodstuffs and other means of subsistence. In any economy population assumes two roles: it is both a productive and a consumptive agent. In the underdeveloped countries, consumptive needs have tended to outdistance productive abilities. In non-Communist Asia, for example, population has increased about 27 per cent over the pre-war level, whereas the production of rice—the primary staple food of the Orient—has expanded only 18 per cent.<sup>6</sup>

The "population explosion" retards economic growth because such growth demands restraint from current consumption to add to the stock of capital goods. The problem assumes more severe proportions when a large share of the population already exists on a subsistence level. In order to raise per capita incomes the rate of growth in production must exceed the rate of population growth. Population pressure also tends to accentuate other problems, it contributes to unemployment and underemployment, social discontent and to political instability.

Various solutions to population density have been suggested. Thus, birth control has been proposed. But it is generally not feasible due to ignorance, customs or religious restraints. Emigration could prove a partial remedy but mass international population movements have been precluded since the early 1900's when many countries instituted selective immigration. A major alternative is an accelerated rate of growth in productive capacity.

*Limited savings.* A third obstacle to economic development is closely related to population pressure. It is the low rate and volume of savings. Savings, the difference between production and consumption, is mandatory for capital formation which in turn permits an enlargement of productive capacity. Resources must be diverted from the creation of consumer goods to the creation of producer goods if future

<sup>5</sup> The average annual increase in world population is estimated at 1.7 per cent. For Asia, the estimated annual increase is 1.8 per cent; Africa, 1.9 per cent, Oceania and South America, 2.3 per cent, and for Central America, 2.7 per cent. See United Nations, 1959 *Demographic Yearbook*, 1960, p. 127.

<sup>6</sup> See *The Mutual Security Program Fiscal Year 1960*. Department of State, Department of Defense and International Cooperation Administration, Washington, D. C., 1959, p. 120.

output is to be expanded. But reduced consumption, or higher savings, is difficult and entails sacrifice where subsistence levels are already near the minimum.

The paucity of savings in the underdeveloped areas, which range from 3 to 8 per cent of gross national product as compared to 15 per cent in the United States, stems from several factors. An underdeveloped country is subject to a vicious circle: Savings are low because of low income; income is low because of inadequate productive capacity and capital formation, and capital formation is low because consumption is high, or savings low. Too, the volume of savings is low because attitudes do not foster thrift and frugality. Another factor is that banking facilities and organized capital markets to channel savings into productive ventures are frequently inadequate.

*Foreign exchange shortage* An important additional obstacle to economic development is the shortage of foreign exchange, or the inability to obtain sufficient external resources. Foreign exchange is essential for the importation of capital goods, equipment, and other items which cannot be produced domestically because of the present state of technology and the low volume of domestic investment. External resources, by complementing and hence providing a more efficient use of internal resources, permit borrowing countries to expand productive capacity with less curtailment of domestic consumption.

Normally, during early stages of development, a country secures foreign exchange by exporting goods and services and by borrowing from abroad. Attempts to expand the supply of foreign exchange encounter difficulties. In most instances, the underdeveloped countries depend extensively upon the exportation of one or a few types of raw materials, and these frequently face an inelastic demand. Accordingly, increased shipments of such materials, facilitated by lower prices, may result in a smaller volume of exchange receipts. A closely related factor hindering development is that world market prices of raw materials fluctuate considerably, and this results in an unstable flow of exchange receipts and contributes to balance of payments difficulties.

The supply of foreign exchange is also augmented by an inflow of capital from private investors. However, this inflow has been insufficient to insure an adequate growth in foreign exchange holdings. The flow of private investment has been retarded by such factors as political instability, East-West tensions, and high returns on capital in the advanced countries. The great need for foreign exchange, coupled with the scarce supply, has induced many underdeveloped countries to initiate exchange controls in an attempt to assure that receipts are employed in what is regarded as the optimum fashion.

*Influence of the past.* Customs and tradition in the underdeveloped areas—the influence of the past—impose a significant impact upon economic activity. Since this influence varies considerably from area to area, its importance as an obstacle to economic development can best be illustrated by briefly examining a few cases.

Conspicuous consumption, which occurs primarily among the rich of these areas, tends to dissipate what might otherwise be savings to be mobilized for productive ventures. Rigid class barriers, which make it difficult to seek a higher social and economic status, tend to discourage individual incentive and the search for self-improvement. Barriers to occupational mobility restrain the pursuit of a better economic position, thus discouraging the growth of a professional group, an entrepreneurial class, skilled workers, and a more productive group of unskilled workers. Strong family or tribal bonds discourage geographic mobility, young workers often hesitate to accept employment elsewhere even if monetary rewards are greater. Immobility of the labor force is one of the factors contributing to the high rate of underemployment in agriculture.

In a variety of ways the influence of the past survives to mold the present environment. Reverence for custom and tradition itself inhibits the change necessary for economic development.

## Foundations of Economic Development:

### *Laissez Faire, Directed and Planned Economies*

The philosophy of most Western countries toward economic development has traditionally been steeped in *laissez faire*. The belief that self-interest is compatible with national interest dates back to the Physiocrats, Adam Smith, and the decline of Mercantilism. Western economies still reflect this heritage and are dominated by it, though there are indications of an evolution in ideas manifested in the changing role of government. *Laissez faire* has provided the foundation for the early stages of development in most Western economies. Although governments did play a role in the process, it was generally restricted to providing a favorable framework within which private enterprise could flourish.

*Modern trends in governmental participation.* A number of world events since the late nineteenth century have cast some doubt on the wisdom of complete reliance on *laissez faire* to promote economic development and to maintain national prosperity. One significant event was

the rapid transition of Japan from a semi-feudal to a modern industrial economy. Under rigid direction and control, the Japanese government was able to by-pass some of the normal steps in development and thus accelerate the tempo of growth. While the means by which the objectives were achieved may be questionable and incompatible with Western ideals, modernization did proceed in a manner different from *laissez faire*.

A second significant event in the twentieth century was the Communist triumph in Russia and the ensuing transformation of this country to a first-rate world power within the span of fifty years. Again, while the techniques employed are not acceptable to the Western mind, the growth rate obtained is impressive.

Other events which have shaken the faith in a minimum of governmental action stem largely from the economic depression of the thirties. Since that time the United States government has undertaken more extensive intervention in economic life. Great Britain, Sweden and other nations have resorted to more drastic measures in an effort to maintain prosperity and economic growth.

*Laissez faire and economic development* The above examples are not cited in an attempt to prove that *laissez faire* is not a sufficiently solid foundation upon which the underdeveloped countries can hope to build their economies. Rather, such examples are suggested to illustrate that *laissez faire* is not a requisite for economic development and that the *laissez faire* doctrine does not today dominate economic thinking as it did in times past. Governments are likely to play a more decisive role in the economic activity of the present underdeveloped countries than they did in the past of the currently advanced ones.

The high degree of governmental participation in the present drive for economic development is exemplified by the governments of India and Communist China, both of which are involved in a considerable amount of planning, direction and coordination of resources. Beyond this, the similarities end. Although the Indian government engages in central planning and to a certain extent in active production, it relies extensively on individual action and private enterprise to perform important productive functions essential for economic growth. The Chinese government, on the other hand, deliberately subjugates individual action and bases virtually all economic performance on group participation and collective operations to advance the growth rate. The measure of success attained by these two governments, with their differing basic philosophies, will very likely influence the conduct of other developing nations.

## Methods of Economic Development

Generally, the underdeveloped countries recognize that to effectuate economic growth certain domestic conditions must be altered and obstacles surmounted. Their social, economic and political institutions have not been conducive to the material progress which characterizes other areas. They seek means to overcome their predicament and to accelerate the rate of economic growth.

*The role of government.* The governments of underdeveloped countries must assume a forceful role if their respective economies are to improve. Active governmental participation conceivably can range from providing a framework within which private enterprise can function as a minimum, to a maximum where the government replaces private enterprise completely.

Whatever the degree of government participation, it must create and maintain essential basic institutions such as enforceable contracts, protection of property and a reliable and flexible medium of exchange. Government may also be called upon to provide social capital, i.e., investment in resources such as housing, schools and hospitals which are indispensable to a modern economy but which frequently do not afford a profit adequate to attract private enterprise.

*Active participation by governments.* Many governments believe that, even with the introduction of social capital and a favorable environment, resources are not being allocated rapidly and effectively. As a result they have assumed a more active role in the use and coordination of resources and have implemented a number of techniques to achieve this objective.

One major problem has been the low volume of savings which impedes capital formation. This situation has been alleviated in part by increased taxation, where possible. The revenue obtained has been applied to a variety of government projects or extended as loans to private enterprise. A number of countries have development banks which channel tax receipts and other funds into projects which appear essential for economic growth.

In view of the scarcity of foreign exchange, the governments of most underdeveloped countries have resorted to exchange and import controls. These controls are generally part of programs designed to conserve foreign exchange for such imports as producers' goods, which are vital for economic growth and which cannot be readily produced domestically.

Other forms of import barriers have been imposed in some cases especially where domestic unemployment or underemployment pre-

vails. Labor, whether employed or unemployed, remains a social cost and hence might as well be utilized to produce items which are normally imported even if they can be obtained more cheaply from abroad.<sup>7</sup>

*Governments and private enterprise.* Government planning agencies in many underdeveloped countries have concluded that an insufficient amount of resources is being allocated to certain key industries, such as power, communications and transportation. These industries require a large initial outlay and, because of the length of time required to complete the facilities, frequently do not provide an immediate return to private investors. Where private enterprise is unwilling or unable to enter these fields, governments often construct the facilities. For similar reasons, government operations have been undertaken in various other fields, such as iron and steel, mining and other heavy industries. In India, opinion holds that the development of certain industries cannot be allowed to depend upon action in the private sector, that the government must encourage private enterprise and even operate some strategic industries.

Such governmental participation does not always supplant private enterprise—it may merely complement it. Governmental ownership of basic facilities such as power, communications and transportation should reduce costs in other fields and act as an inducement to private enterprise. Joint public-private operations have been initiated in other instances on the premise that some types of production would not otherwise be undertaken.

Finally, public enterprise has been considered useful for initiating production in certain lines and eventually turning the operations over to private hands. In Chile, the state has initiated productive ventures on the assumption that equity capital would eventually be made available to the private sector.

Private enterprise, insofar as it is induced to undertake operations in a given industry, is often held to provide, under most circumstances, a better use of resources than public enterprise. It cannot afford to waste resources since production costs are a major factor determining the profitability of operations. Private enterprise also creates an atmosphere conducive to individual initiative and freedom.

*Specialization vs. diversification.* The present underdeveloped countries have long specialized in the production of certain raw materials. At the same time their incomes have remained relatively low.

<sup>7</sup> The General Agreement on Tariffs and Trade authorizes the underdeveloped countries to use import restrictions under certain circumstances to encourage infant industries (Article XVIII). Also, countries are permitted to utilize quantitative restrictions to forestall a serious decline in monetary reserves (Article XII).

Other countries have diversified, become industrialized, and have generally shown marked increases in material gain. In view of this, underdeveloped countries frequently conclude that industrialization is the necessary and sole requirement for higher per capita incomes. Income, of course, depends not upon the type of economic endeavor but rather upon the degree of productiveness accomplished within any particular type of pursuit. Yet while industrialization and economic advancement cannot be regarded as synonymous, under some circumstances a certain amount of industrialization may prove to be the only feasible solution to the problem. In their roles as planning agencies, governments of the underdeveloped countries must make decisions concerning continued specialization in primary-goods production as opposed to establishment of a certain amount of diversification.

*Advantages and disadvantages of specialization.* In making this decision a variety of factors needs to be taken into consideration. Extended specialization in primary products natural to the region, offering the possibility of increased exports and hence a greater volume and variety of imports, is advantageous in that it results in a minimum of social and economic change. A second benefit is the possibility of increased productivity in the agricultural sector for example, with hybrid seeds, improved strains of livestock, crop rotation, irrigation, and other methods which utilize local resources more extensively than industrialization.

One of the more difficult situations involved in agricultural specialization relates to a variety of problems falling under the term "land reform." Land reform implies different things in different countries, but it is generally conceived as a type of change which will bring about a better allocation of resources. It may refer to the ownership of land, size of holdings, taxation of property and rights of tenants, among other things. Land reform is a particularly difficult problem because of its political and social implications. The solution which is most conducive to higher agricultural productivity and economic development may or may not be acceptable to vested interests or to the population at large.

A number of serious disadvantages accrue with continued specialization. An inelastic foreign demand for raw materials may preclude an expanded supply of these items if exchange receipts are to be increased. Additionally, the demand for these products is presumed to be income inelastic, as world incomes increase, the demand for raw materials does not necessarily increase as rapidly. Another factor is that, with a relative over-abundance of agricultural labor, a country may find it is difficult to utilize the labor force fully and effectively. Increased agricul

tural productivity may tend to make labor even more redundant and difficult to assimilate within this sector.

A danger associated with specialization is that through the export of one or a few types of products, the economies remain subject to substantial changes in foreign exchange earnings caused by minor fluctuations in economic activity in advanced countries. Extreme concentration on one or a few products ties the fortunes of the underdeveloped countries closely to market conditions in major importing areas. Since a decline in demand for their narrow range of products is not cushioned by a steady flow of exchange receipts from other sources, they may be placed in a precarious position.<sup>8</sup>

*Advantages and disadvantages of diversification.* From the foregoing, it follows that intensified raw material production may not offer an adequate long-run growth potential for some areas. As another alternative, an underdeveloped country can attempt a certain amount of diversification. This diversification may be introduced with the initiation of small industries which, at least in their early development, provide goods and services for local markets. In some cases, further processing of raw materials may be feasible before exporting them. According to one author, enterprises may be encouraged which are either "foreign-exchange-saving," in which case output replaces usual imports, or "foreign-exchange-earning," in which case output actually enters world markets.<sup>9</sup>

Industrialization entails a major disadvantage in that generally a larger volume of external resources—equipment, supplies and materials—must be available before operations can be implemented. In many underdeveloped countries some of the ingredients of industrialization, including specialized types of equipment, entrepreneurial and managerial ability, are not always available locally and may be difficult to obtain from foreign sources. The structural changes which accompany industrialization are extensive and require a shift of resources and a greater degree of urbanization.

The advantage of industrialization is that it can yield a practical way of utilizing an abundant supply of labor. In view of the relative availability of resources, industries utilizing a high ratio of labor to capital are most feasible economically. Items which are neither income-

<sup>8</sup> The foreign exchange problems encountered by the "one-crop" economies are examined more carefully in chapter 26, which considers international commodity agreements.

<sup>9</sup> See Krause, Walter *Economic Development* San Francisco: Wadsworth Publishing Company, Inc., 1961, pp 138-140.

nor price-inelastic on the world markets may be produced and hence permit an expansion of foreign exchange receipts. In this connection diversified exports enable a country to spread the risks; a decline in demand for one product bears less heavily on its balance of payments position.

Unfortunately, perhaps, many underdeveloped countries have come to view programs of extreme industrialization as the only method of raising national incomes. In so doing there has been a tendency to underestimate gains which can be made through improvements in the primary-goods sectors. But the policies best suited to accelerate growth will vary, depending upon the nature of conditions in each country. For these countries in a position of dependence upon a narrow range of export products and with a high rate of unemployment or underemployment, a certain degree of industrialization may be a desirable approach. Actually, more industries need not necessarily result in a net reduction in specialization. To the extent that workers are not fully employed, primary production might be maintained and still a portion of the labor force can be devoted to the manufacture of other types of goods, partly for domestic use and partly for export.

*The need for external assistance.* In the pursuit of economic growth, many underdeveloped countries have experienced difficulty in raising the domestic resources necessary to fulfill the requirements for a satisfactory rate of growth. Many of them have found it impossible to hold down the level of consumption. Accordingly, when the desired amount of private and public investment takes place money demand exceeds real capacity and inflation occurs. It is unlikely that most underdeveloped countries, under other than a totalitarian government, will be able to arrive at a stage of self-sustained growth without substantial external assistance. The international movement of resources not only assists the developing economies, but also facilitates an optimum use of world resources.

*Assistance derived from investment.* To obtain additional external resources, a country's imports should exceed exports of goods and services and the difference be offset by borrowing from private or public sources abroad. Unless this is done, it must become a recipient of grants. Each method has certain advantages. An inflow of private investment (especially direct investment) not only supplies supplementary resources but also facilitates the transfer of skills, business organization, and technology frequently lacking in underdeveloped countries. However, public investment from both national and international agencies is increasing<sup>4</sup> being accompanied by technical assistance.

To assert that an inflow of either public or private capital is essential for development in no way implies it will be forthcoming. Private investment flows primarily in accordance with the degree of business interest relative to the degree of risk. National and international agencies are also loathe to extend credit unless there is adequate assurance of repayment. Probably the most important factor in attracting capital is that the governments be stable, mature and capable of protecting property, all of which reduces the risk factor. Additional incentive can be provided by favorable tax laws and equitable earnings and capital remittance rights.

*The nature of other forms of assistance.* All forms of investment of course require repayment, which means that eventually a borrowing nation must be able to attain an export surplus. For some of the extremely poor countries, eventual repayment appears highly improbable in the immediate future. Here the receipt of grants, soft loans and long-term public loans may be essential. Such assistance is primarily given at the discretion of the donor or creditor and may be motivated politically rather than economically. A number of countries occupying strategic geographic positions, such as Afghanistan, India and Indonesia, have received economic assistance from both the United States and the Communist Bloc. Since the end of World War II, both national and international agencies have augmented assistance, motivated largely by the relatively inadequate flow of private capital and by the growing awareness of the political implications of widespread poverty.

*Summary and conclusions.* Economic development of these areas may require external assistance, but the essential nourishment of cumulative growth must originate from domestic sources. In addition, economic advancement cannot be accomplished in a short period of time or without sacrifice on the part of the population. Furthermore, such sacrifice will not offer immediate rewards in the form of higher consumption standards if self-sustained growth is to be attained. The expansion of an economy's productive capacity in the form of schools, roads, equipment and factories is of long duration; only when attained, can real benefits be reaped.

In general, the task of the planning agency must be to enlarge the productive capacity of the economy. This requires making a fuller and more efficient utilization of local resources, encouraging the use of externally borrowed or granted resources, and encouraging the diversion of some resources into use in capital formation. In many instances, economic problems will be solved in part by influencing non-economic factors. For example, the removal of social and political impediments will help foster economic development.

## QUESTIONS AND PROBLEMS

1. Describe the major obstacles to economic growth in the underdeveloped regions.
2. Many underdeveloped nations have been called "one-crop" economies. What is the significance of this characteristic in terms of prospects for economic growth?
3. "Since the labor force represents a factor of production, the population density which characterizes many backward nations might be considered a valuable asset in accelerating the rate of economic growth." Comment on this statement.
4. What factors make it difficult for underdeveloped areas to expand their supply of foreign exchange? What actions might they take to stimulate an inflow of foreign capital?
5. "In an analysis of the underdeveloped countries, it is impossible to consider economic factors independent of political and social factors." Evaluate this opinion.
6. What is the economic and political significance of the underdeveloped areas within the context of the cold war and increased international tensions?
7. Is continued specialization, as embodied in the doctrine of comparative costs, the best alternative for these areas?
8. Many Americans express the feeling that United States aid should not be extended to those nations which do not rely completely upon the principles embodied in laissez faire and private enterprise. Comment.
9. It is frequently suggested that, while economic growth may be assisted from external sources, the essential impetus and nourishment of cumulative growth must originate domestically. What is the basis for this suggestion?

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## United Nations Financial Programs

"There is a curious notion that the protection of national interest and the development of international cooperation are conflicting philosophies—that somehow or other men of different nations cannot work together without sacrificing the interest of their particular nation. There has been talk of this sort—and from people who ought to know better. . . ."

With these words Secretary of the Treasury Henry Morgenthau Jr. closed the conference at Bretton Woods, New Hampshire, on July 22, 1944, where the Articles of Agreement of the International Monetary Fund and the International Bank for Reconstruction and Development were hammered out. They marked the start of an era in international financial relations in which cooperation was expected to take its place beside competition in world affairs.

Efforts toward this goal were sponsored by the United Nations and took the form of a number of international arrangements designed to foster political, social and economic cooperation. Some of the more ambitious programs inaugurated were in the general area of international trade and finance. This chapter examines the institutions of the United Nations designed to cope with problems in the realm of international finance—the International Monetary Fund, the International Bank for Reconstruction and Development, the International Finance Corporation and the International Development Association.

### The Nature and Significance of International Financial Cooperation

Cooperation in international finance was motivated by a number of factors. In general, the over-all objective was to achieve a high level of international exchange and a more economic use of the world's resources. The four institutions were designed to cope with the fundamental factors causing restricted trade. As a means of attaining this objective, the institutions provide assistance for countries experiencing temporary balance

of payments deficits, for those areas which suffered severe war damage to productive capacity and for regions undertaking programs of economic development.

The need for monetary cooperation was evident in the years preceding World War II. The demise of the gold standard was not followed by cooperative payments arrangements. Governments were unwilling to subject their respective economies to adjustments arising from changes occurring in the external world, and economic nationalism plunged the world into monetary disorder.

International cooperation was necessary to avoid a recurrence of competitive exchange devaluation and unilateral commercial policies which were responsible for the ensuing decline in world transactions during the thirties. World War II exaggerated these problems; frequently it was necessary to resort to bilateral arrangements for the maintenance of even a minimum level of trade. Many nations were concerned about these conditions and hoped that a high level of multilateral trade would be restored in the post-war period.

For success in international cooperation, domestic policies of individual nations, especially those related to the level of production and employment, required coordination on a world-wide scale. However, such international cooperation was acceptable to the various governments only if they were able to retain a certain degree of freedom of action on domestic matters. Essentially, the problem was one of inducing member governments to pursue domestic employment policies which were compatible with international cooperation and harmony in world monetary affairs.

*The Keynes-White debate.* The post-World War II planners recognized that a return to the nationalistic policies prevailing in the 1930's might be disastrous. They also generally recognized that a revival of the nineteenth century gold standard was hardly feasible. Still it was hoped that some type of organized cooperation could preserve stability of exchange rates, provide currency convertibility and restore multilateral trade.<sup>1</sup> Most of the early aspirations centered on some form of global institution capable of dealing directly with conditions of external disequilibrium. Such an institution would assist countries experiencing deficits

goals of the two schemes, relative stability of exchange rates coupled with a degree of national independence in domestic affairs, were similar, the proposals differed on the means by which to achieve the objectives. One major difference had to do with the extension of credit. The Keynes Plan proposed an automatic extension of credit to deficit nations which would assume the form of overdraft privileges against an international organization. The White Plan proposed that credit needed by deficit countries be financed out of contributions established in advance by member countries. In addition, assistance would not be extended automatically, in some instances, the deficit nation would be expected to meet certain requirements before credit was made available.

A second difference concerned the quotas of member governments. The White Plan recommended a quota based on each country's holdings of gold and free foreign exchange, the magnitude and fluctuations of its balance of payments, and its national income. These quotas would determine the voting rights of member countries, the amount of credit which could be obtained from the organization and each member's financial contribution to the organization. The Keynes Plan suggested a quota based on a percentage of a country's exports and imports during some pre-war period. This quota would determine the share of each participant in the management of the organization and the extent to which a country could utilize its available credit.

The plans agreed that the organization should provide financial assistance to be used only for balance of payments purposes. The problem of a shortage of long-term credit for other objectives was to be assigned to a complementary international institution.<sup>3</sup> The International Monetary Fund was the result of a compromise which, while favoring the White Plan, also reflected the influence of the Keynes' proposal. The complementary institution created to provide long-term credit was the International Bank for Reconstruction and Development.

*The Bretton Woods Agreements* By the time representatives of the major nations of the world assembled in Bretton Woods for consideration of post-war cooperation, the objectives were well known. Both the White and Keynes Plans had undergone considerable study and discussion.<sup>4</sup> The hope of the conference was that international planning could partially succeed national planning and thus avoid the sometimes chaotic conditions of the foreign exchanges during the inter-war period. Finally, there

<sup>3</sup> For a more complete comparison of the White and Keynes Plans, see Robinson, Joan, "The International Currency Proposals," in *The New Economics*, (Ed.) Seymour E. Harris. New York: Alfred A. Knopf, 1950, pp. 342-353.

<sup>4</sup> The Bretton Woods conference was attended by all member countries of the United Nations. The major nations which do not participate in the international financial institutions elaborated there include Switzerland and the U.S.S.R.

was a desire that the flow of international investment would be adequately revived to assist in world economic adjustment.

The approach at Bretton Woods, which was strongly international in philosophy, stressed world-wide planning and organization. An important basic assumption, which reflected the idealistic nature of the approach, was that international trade would flourish in a framework of free currency convertibility after the post-war transition. The use of quantitative import controls and discriminatory trade practices was to be avoided. An integrated world economy characterized by a high level of multilateral trade was anticipated. This integration would be realized as governments influenced their respective economies in a manner consistent with international rules and policies. This approach was embodied in the International Monetary Fund.

### ✓ International Monetary Fund

The major function of the International Monetary Fund (IMF) is to assist countries in their balance of payments problems. By aiding countries to maintain stable rates of exchange and to overcome temporary balance of payments disturbances, it was hoped that self-seeking commercial policies could be dampened and that exchange controls, especially over current transactions, could eventually be abolished. The IMF, as a medium for consultation and association, for research and the dissemination of information, is also an agency for promotion of cooperation on international monetary affairs.

*Operations of the IMF.* Assume that at a given rate of exchange, a member country encounters external disequilibrium: for example, the amount of foreign exchange it desires exceeds the amount it earns. Rather than taking recourse to an immediate currency devaluation or imposition of trade restrictions as might have happened in the thirties, it is expected to draw on its own stock of foreign exchange. If its holdings are reduced and the deficit persists it is afforded an opportunity to borrow a certain amount of foreign exchange from the IMF. In some cases, the borrower may be expected to curb domestic inflationary tendencies which increase the pressure on its balance of payments.

If the deficit persists despite the assistance from the IMF and the application of appropriate domestic measures, the conclusion might be drawn that the country's rate of exchange is overvalued. The final step is a depreciation of the currency, which is generally accomplished after being sanctioned by the IMF. Thus the IMF assists in maintaining stable exchange rates and orderly adjustments in event of balance of payments difficulties.

In the illustration, a country is experiencing balance of payments difficulties at a given rate of exchange. The determination of this rate was to have been one of the first tasks undertaken by the IMF. This appeared to be a difficult task because of war-time inflation, reduced levels of exports, the destruction of productive capacity, the need for imports and shifts in trading patterns. Accordingly, the existing rates of exchange which apparently suited the circumstances and desires of the members were accepted on the condition that they would be altered subsequently if warranted by conditions.

If a country is exhausting its supply of reserves at a given rate of exchange, it can secure credit from the IMF for financing what is presumed to be a temporary balance of payments deficit. This credit is made available from a fund created by the contributions from all member nations. There are, however, limits on the amount which a deficit member can obtain from the Fund. The maximum limit is normally equal to 125 per cent of the borrowing country's assigned quota, but generally the maximum available in any one year is an amount equivalent to 25 per cent of the country's quota.

In the process of obtaining credit from the Fund, the deficit country exchanges its own currency for the foreign currency or currencies of which it is experiencing a shortage. When the debtor's external problems are eased, it is expected to return the borrowed currency and retrieve its own currency within three to five years. Repayment is encouraged by the service charge, up to 5 per cent, on borrowed currencies. Since the IMF stands ready to extend credit to deficit countries, the need for exchange controls, import restrictions and currency depreciation is lessened.

Since a country can borrow a maximum sum equivalent to 25 per cent of its quota in one year for several years, it is accorded a limited amount of balance of payments assistance throughout the period. Should the country's deficits be large and chronic, it becomes obvious that this country's balance of payments is in a state of "fundamental disequilibrium" and that its rate of exchange may not be realistic. Hence it may seek to devalue its currency. Devaluation, under most circumstances, tends to correct disequilibrium due to excessive imports, since one result is that exports are encouraged and imports discouraged. The country may exercise independent action for a devaluation of 10 per cent or less. If the devaluation desired is greater than 10 per cent, the country must secure agreement of the Fund.

According to the Articles of Agreement, an alteration of the rate of exchange is authorized if such a measure is necessary for correction of a "fundamental disequilibrium." However, the Articles fail to define a

situation of fundamental disequilibrium. In practical applications, a change in the exchange rate is normally sanctioned when a country experiences a persistent deficit which cannot be corrected by means other than domestic deflation or more restrictive import barriers.

Because the IMF was designed to assist countries in balance of payments adjustments, it was presumed that after the post-war transition, free currency convertibility would become the rule of the day. Although the IMF Agreement forbids exchange controls on the current account, it permits certain exceptions. If the demand for a country's currency is so great that the IMF's supply of it is threatened with depletion, the IMF can declare that it is a "scarce currency," thus permitting other members to impose exchange controls on that particular currency and to ration the supply to domestic buyers. The IMF allowed members to maintain existing exchange controls temporarily, but these were to be eliminated after the post-war transition. A majority of members retained controls under this provision long beyond what was considered the post-war transition. Subsequently, many of them were able to accept the obligations of convertibility for their currencies. Since 1952, the countries using exchange controls have been required to consult periodically with the IMF on the need for the continuance of such restrictions.

To assure that members follow the principles embodied in the Agreement, the IMF retains the power to deny access to its resources to deficit countries which fail to make a serious effort to correct external disequilibrium and to those which violate the Articles of Agreement. The IMF has the authority to expel a member if it freely and independently violates the code of behavior set forth in the Agreement.

*Structure and organization of the Fund.* The financial resources of the IMF are derived from the contributions of each member country. Contributions are based on a quota assigned to each member; 25 per cent of it must be paid in gold and 75 per cent in the country's own currency. Members agreed, in 1959, that an expansion in quotas was necessary if the Fund was to be adequately prepared for future contingencies. The Fund's resources consisted of \$14,861 million in gold and national currencies in July 1961. This amount represents an increase of about 50 per cent in financial resources over previous years.

A country's quota, which is determined by the Fund and may be based on its relative importance in terms of external trade, national income and population, is significant in two respects. First, it determines the drawing rights or the amount of credit a country can receive in the event of balance of payments difficulties. Second, it establishes the voting power of each member. Every country has 250 votes plus one vote for each

\$100,000 of its quota. Votes are also gained as other members borrow its currency and lost as it uses other members' currencies.

The managing personnel of the IMF consists of the Board of Governors, the Executive Directors, the Managing Director and the staff. The powers of the Fund are vested in the Board of Governors, which consists of one governor and one alternate appointed by each member country. The Board determines the basic decisions relating to over-all policies of the Fund. Execution of the decisions is the responsibility of the Executive Directors, ten of whom are appointed by the ten largest quota countries and seven elected by the vote of the other members. The Executive Directors also select a Managing Director. The staff, which is under the direction of the Managing Director, conducts the day-to-day business of the Fund.

The quotas and voting powers of the major member nations of the IMF in April 1961 are shown in Table 24.1. By January, 1962, over seventy nations had joined the Fund. In terms of importance, the United States and the United Kingdom are dominant. Together they contribute about 41 per cent of the total financial resources and control about 37 per cent of the total votes.

TABLE 24.1  
QUOTAS AND RELATIVE VOTING POWER OF THE MAJOR MEMBERS OF THE  
INTERNATIONAL MONETARY FUND AS OF APRIL 30, 1961

Member	Quota (in millions of dollars)	Quota as a per cent of total	Votes as a per cent of total
United States	4,125.00	27.78	25.00
United Kingdom	1,950.00	13.13	11.90
France	787.50	5.30	4.89
Germany, Federal Republic of	787.50	5.30	4.89
India	600.00	4.04	3.78
Canada	550.00	3.70	3.46
China	550.00	3.70	3.46
Japan	500.00	3.37	3.16
All other members	5,000.00	33.68	39.48
Total	\$14,850.00	100.00	100.00

Source: Adapted from *Annual Report 1961 International Monetary Fund* Washington: 1961. Pp. 138-141.

*Success of the International Monetary Fund.* As is true of other international agencies, it is difficult to determine how successful the IMF has been because one does not know what the international financial conditions would have been in its absence. From all appearances, however, the Fund has fostered international monetary cooperation, prevented competitive devaluation and discouraged a more intensive use

of exchange controls. The IMF extended \$4,022.3 million worth of credit to countries experiencing balance of payments deficits during its first fourteen years of operations. As shown in Table 24.2, the most important borrowers include Brazil, France, India and the United Kingdom.

The IMF is also active in research in the area of international finance. Its *Annual Report* contains descriptions, with detailed supporting data, of world financial developments for the preceding year. The Fund conducts pioneering work in the field of balance of payments accounting. Its annual *Balance of Payments Yearbook* provides the basic source of statistical information for the balances of payments of IMF members.

The achievements of the IMF were disappointing in terms of one initial objective. In spite of the fact that quantitative controls were to be eliminated by the end of the post-war transition period, many participating countries continued to employ restrictions for balance of payments purposes long beyond that date. This may suggest that the task

TABLE 24.2  
BALANCE OF PAYMENTS ASSISTANCE EXTENDED BY  
THE INTERNATIONAL MONETARY FUND THROUGH APRIL 30, 1961  
(in millions of dollars)

Member	Amount
Argentina	217.5
Australia	225.0
Brazil	308.5
Chile	104.7
France	518.8
India	300.0
Japan	249.0
Netherlands	144.1
United Kingdom	861.5
Other countries	1,093.2
Total	4,022.3

Source Adapted from *Annual Report 1961* International Monetary Fund. Washington, D C 1961. P. 153

assigned the IMF was more serious than had been anticipated and that international disequilibria were more severe than the original planners recognized.

One might conclude that the resources and powers of the Fund were originally inadequate to deal with the disorders encountered. The problem of inadequate financial resources was partially resolved when quotas were expanded by 50 per cent in 1959. The Fund has also some authority to compel member countries to develop domestic programs which are consistent with external equilibrium. In 1960, for example, the Iranian economy encountered a serious drain on foreign exchange reserves. As a condition for further loans from the IMF, the Iranian

government was required to initiate a program designed to balance its domestic budget and curb internal inflation. Furthermore, since 1952, those countries which have maintained the exchange controls they utilized at the time of initial participation in the Fund are obliged to consult annually with the Fund. Through consultation, the Fund has succeeded in inducing several countries to refrain from tightening exchange controls. In conjunction with this, it offers suggestions to assist in an eventual elimination of quantitative restrictions.

The failure of the Fund to realize completely all of the expectations of its founders may be due to deepseated causes. It was the hope of the authors of the Bretton Woods Agreements that once the war and its aftermath were over the world would return in an orderly fashion to the system of economic relationships and international payments which characterized multilateral trade in the past. However, the post-war world differs in many respects from that which existed previously. Some of the practices which were believed to be extraordinary and temporary appear now to be ordinary and permanent. In other words, the Fund was designed to cope with a world of economic relationships which has partially disappeared. In addition the Marshall Plan and successor United States grant and loan programs rendered recourse to the Fund's resources a less pressing need during its early years.

Only the future can tell whether or not the Fund possesses sufficient flexibility under its present Articles of Agreement to function effectively under conditions of today and tomorrow. Already a number of suggestions for changes in its structure and operations have been made; several of these are discussed in chapter 7. Article XVII of the Fund's Articles of Agreement provides an orderly procedure for amendment and there is no reason to believe that important changes will not be taken if needed to enable it to work more effectively.

### **The International Bank for Reconstruction and Development**

The International Bank for Reconstruction and Development (IBRD or World Bank) was organized in conjunction with the International Monetary Fund and the two institutions complement each other. The IMF furnishes short-term credit to enable a country to withstand temporary balance of payments deficits. The IBRD provides long-term credit for reconstruction and development projects and does not directly assist in solving balance of payments problems.

The unsatisfactory results experienced with some international investment in the pre-war period served as a warning that unless investment were encouraged in some fashion there might be an inadequate distribution of world resources for the needs of reconstruction and development.

The transfer of international capital had declined substantially during the depression period of the 1930's. During that period and during World War II, foreign investors suffered losses due to defaults, expropriation and physical damage to plant and equipment. In essence, the climate did not look as though it would be conducive to private investment in the post-war period. Past experience supported the belief that a steady and adequate capital outflow from the United States toward deficient areas might not be forthcoming if entirely dependent upon the action of private investors. Accordingly, it was felt that private investment must be encouraged and supplemented through lending by an international agency. The IBRD was created for this purpose and commenced operations in 1946.

*Operations of the IBRD.* The major function of the IBRD is to provide loans for countries seeking to rebuild or expand their productive capacity. During its early years of existence, the Bank directed most of its support toward the reconstruction of several war-ravaged countries. However, it soon became evident that reconstruction needs were too large to be successfully accommodated by this institution alone. Fortunately, the advent of American aid under the Marshall Plan in 1947 relieved the World Bank of some of its reconstruction work. The IBRD has focused attention in more recent years on the requirements of areas striving for economic development.

The World Bank extends credit for projects which it deems worthwhile to member governments and to private businesses which are able to secure a guarantee from their governments. It generally provides the foreign exchange needed for purchasing the external resources essential for a project. The borrower is expected to possess or to raise the funds needed for procurement of domestically available resources.

It was originally anticipated that a large share of the efforts of the Bank would consist in the guarantee of loans granted to private enterprises. Actually, the Bank's capacity to guarantee loans has rarely been utilized. Instead, loans have been financed directly out of the Bank's own resources or, more importantly, out of the resources which it has been able to borrow on the money markets of its members, especially those of the United States.

Loans from the Bank are of a commercial type with specified rates of interest and periods of amortization. Proposed projects are carefully screened to assure that they merit this type of financing, that they are productive and that a reasonable expectation of repayment exists. The Bank is not authorized to make grants and "soft loans," but it does reserve the power to relax the terms of credit should a debtor nation encounter hardships in making repayment. To make certain that loan

proceeds are utilized in the most efficient manner and to encourage multilateral trade, loans extended by the Bank are not tied, proceeds may be utilized for acquisition of items from any country.

As shown in Table 24.3, the IBRD has made loans in many under-developed areas for projects which were not undertaken by private enterprise. This type of loan is characteristic of those made by the Bank. It is not authorized to undertake projects which might otherwise be financed by private enterprise; it is neither to compete with nor replace private investment. Since the Bank complements commercial lending, it assumes the role of a lender of last resort.

The Bank has extended loans equivalent in value to \$5,068 million through June 1960. The interest rate has generally varied from 4 to 6 per cent; normally all loans are to be amortized in twenty-five years or less. A large portion of loans is directed toward the development of basic industries.

TABLE 24.3  
WORLD BANK LOANS BY PURPOSE THROUGH JUNE 30, 1960  
(millions of U. S. dollars, net of cancellations and refundings)

Purpose	Amount
Development Loans: Total	4,571.1
Electric Power	1,604.9
Transportation	1,526.2
Communications	23.9
Agriculture and forestry	375.7
Industry	835.4
General development	205.0
Reconstruction Loans: Total	496.8
Grand Total	5,067.9

Source: *Fifteenth Annual Report 1959 1960* International Bank for Reconstruction and Development.

After a loan has been granted, the actual use of funds is carefully observed by the Bank to assure that receipts are not used in an unpre-scribed manner. The Bank employs a staff of experts in the areas of business administration, economics and engineering to assist in the original screening, construction and operation of proposed projects.

A typical example of IBRD operations is represented by the loan made to Peru in 1960. The Banco de Fomento Agropecuario del Peru borrowed \$5 million for an eight-year period at 6 per cent. This credit was needed to obtain the foreign exchange necessary for agricultural development. The Banco is the major source of development funds for agriculture in Peru, and it supplements private investment in this type of production. The credit is to be employed to improve irrigation facili-

ties, to make additional land suitable for plantation crops and to establish raw material processing plants. IBRD estimates that a 50 per cent increase in Peru's agricultural output is necessary within the next decade if that nation is to attain a reasonably balanced growth.

The Bank has been active in other roles, it has conducted general economic surveys for numerous countries. It has joined other agencies in providing technical assistance for various areas, and it has cooperated with several member countries in inaugurating development banks and in reorganizing existing banks.<sup>5</sup> Through its staff, the IBRD has been able to furnish guidance apart from its lending activities, especially for the underdeveloped areas. In Nigeria for example the Bank is assisting in a survey which is being conducted to determine the merits of constructing a dam for generation of electric power, navigation, flood control and irrigation.

*Structure of the World Bank* The financial resources of the World Bank were initially set at \$10 billion, which was to be provided by subscriptions from member countries. Only 20 per cent of each country's quota, 2 per cent in gold or dollars and 18 per cent in the country's own currency, was payable immediately. The remaining 80 per cent is subject to call and serves primarily as a guarantee for the Bank's own obligations as it borrows, usually by means of bond issues, various currencies throughout the world to raise funds needed for its loans.

A proposal in 1958 that the present members' quotas be doubled was adopted, thereby increasing the Bank's capacity to extend loans. The augmented subscriptions also remain subject to call and serve to underwrite the Bank as it acquires funds through bond issues floated in different countries. By July 1961, the subscribed capital of the Bank totalled about \$20.1 billion, approximately 90 per cent of which remains on call. The United States is the largest shareholder in the Bank, subscribing to slightly more than 30 per cent of the total stock. Voting powers are comparable to those of the IMF. Organization and duties of the Bank's managing personnel are similar to those of the IMF.

The countries participating in the World Bank are almost identical with the membership of the IMF, membership in the Fund is a requisite for association with the World Bank. Since its organization, membership in the World Bank has steadily increased and by early 1962 it totalled over seventy nations. A few countries have left the organization, Poland

<sup>5</sup> The surveys organized by the IBRD provide a comprehensive description of conditions in certain foreign countries. Some of these reports include *Surinam: Recommendations for a Ten Year Program* Baltimore: The Johns Hopkins Press, 1952, *The Basis of a Development Program for Colombia* Baltimore: The Johns Hopkins Press, 1950, and *The Economic Development of British Guiana* Baltimore: The Johns Hopkins Press, 1953.

and Cuba withdrew in 1950 and 1960, respectively. Czechoslovakia was expelled in 1953.

*Success of the IBRD.* During its first fourteen years of existence, the IBRD made about \$5.1 billion worth of loans to over fifty countries. In view of the demand for international investment during the period, this is a relatively small sum. The major criticism of the World Bank is that it has failed to respond sufficiently to world needs for capital.

However, the Bank is restricted in lending activities by the nature of its structure. The major restraint is that credit must be extended on commercial terms, every project undertaken has to be self-liquidating. Since the Bank has borrowed funds by means of bonds sold to investors, it can hardly make loans for dubious projects or purposes. As a consequence, many types of projects which might be an integral part of an over-all development program, but which are not self-liquidating, are not qualified to obtain financing from the Bank. Yet, when considering loan applications, the Bank does examine the importance of the proposed project in relation to the entire development effort of the country. The limited performance of the IBRD relative to the need for capital indicates that the Bank should be supplemented by sources of capital on more lenient terms.

Granted that Bank operations have been restricted, it must be recognized that the Bank has played an important role in supplementing the flow of funds by private enterprise and a variety of government agencies. The rate of lending by the IBRD showed a pronounced increase in the period 1957-1960. Thus, in conjunction with added financial resources, indicates that its operations may be broadened in the future.

Particularly noteworthy is the role of the Bank in the area of technical assistance and over-all guidance to areas endeavoring to attain a more rapid expansion of productive capacity. The Bank administers an Economic Development Institute which is designed to improve the management of economic affairs in the underdeveloped countries. Participants have included representatives from Asia, Africa, Latin America and Europe.

### The International Finance Corporation

A third institution designed to nurture international financial cooperation is the International Finance Corporation (IFC). The IFC was inaugurated to promote the expansion of productive capacity through direct investment in conjunction with private investors. Thus IFC operations represent a joint venture with private business firms. This is in contrast to the IBRD, which deals almost exclusively with governmental

entities. Since the IBRD generally does not assist private enterprise, the IFC fills a gap in world capital movements and accordingly reinforces IBRD efforts.

*Activities of the IFC.* The major method by which the IFC stimulates private enterprise and investment is through the provision of funds to business firms located in member countries or their dependencies. These funds supplement resources which the firm must already possess. The IFC does not provide capital in excess of 50 per cent of the firm's total assets. However, the minimum capital contribution is normally \$100,000, which can be made available only if the firm is unable to obtain credit elsewhere under reasonable conditions. As is true of the World Bank, IFC operations are conducted on a commercial basis. Unlike the World Bank, the private firm is not expected to obtain a government guarantee. Additionally, IFC investments are restricted to the underdeveloped countries which are members of the organization.

In practice, the IFC purchases non-voting securities of the applicant firm. This indicates that although the IFC shares in the profits and the growth, it does not expect to participate in managing the business. Second, after a period of time sufficient for the business to become established, the IFC sells its holdings to private interests. Purchasers of the non-voting securities are able to convert them into voting stock, which permits the holder to participate in the management of the business. Funds from the IFC's security sales to private interests are re-used by the IFC for purposes of participation in the financing of other ventures. Thus a type of revolving fund is created for continued use in promoting private enterprise. The IFC also acts as an intermediary to bring together private capital, management and investment opportunities.

A \$366 million loan to a privately-owned company in Argentina, Acindor Industria Argentina de Aceros, is typical of the operations of the IFC. The IFC credit will help finance a program for modernization and expansion of productive capacity of Acindor, which manufactures and distributes steel products. The total cost of the program, which is expected to be completed by 1964, is estimated at the equivalent of \$22 million.

*Structure of the IFC.* The IFC, which came into existence in 1956, has an authorized capital stock of \$100 million. Financial resources, derived from subscriptions of member countries, are fully payable and take the form of either gold or dollars. The IFC possesses an advantage in this respect over the other institutions since all financial resources are fully convertible. As shown in Table 24-4, about 50 per cent of the IFC's total capital structure is held by the United States and Great Britain. A country must participate in the IBRD before it can become eligible

for membership in the IFC. Sixty countries were members of the IFC by January 1962.

**TABLE 24.4**  
SUBSCRIPTIONS AND VOTING POWER OF MAJOR MEMBERS OF THE  
INTERNATIONAL FINANCE CORPORATION AS OF JUNE 30, 1961

Member	Subscription (in thousands of dollars)	Subscription as a per cent of total	Votes as a per cent of total
United States	35,168	38.41	31.81
United Kingdom	14,400	14.91	13.16
France	5,815	6.02	5.45
India	4,431	4.59	4.20
Germany	3,655	3.78	3.51
Canada	3,600	3.73	3.46
Netherlands	3,046	3.15	2.96
All other members	26,461	27.41	35.45
Total	98,576	100.00	100.00

Source: Adapted from *Fifth Annual Report 1960-1961* International Finance Corporation, Washington 1961 P. 32.

In addition to lending its own capital, the IFC has authority to borrow funds through the issue of securities. This provides a further source of funds which can be loaned to private enterprise in member countries.

*Success of the IFC* An appraisal of the IFC has limited value because of its recent origio. It has made investments totalling \$44.4 million in projects located in eighteen different countries during the first five years of operations. The major advantage of the IFC is that it is capable of making a type of investment in private firms not envisaged by the World Bank. This increases the flexibility of operations of the four United Nations institutions. Activities of the IFC have generally been welcomed throughout the non-Communist world partially due to the fact that it concentrates on augmenting and sustaining the volume of production undertaken by private enterprise.

### The International Development Association

A fourth international financial institution, the International Development Association (IDA) was formally initiated in 1960. It extended its first development credit during the following year.

*Objectives of IDA.* IDA is designed as a medium through which more advanced nations can assist countries seeking economic growth. The Association is based on the view that economic development in the backward areas is a responsibility which should be shared mutually by the advanced countries. The purpose of IDA is to help those countries

which are in need of external resources, but which cannot reasonably expect to service and amortize the accommodating loans as they fall due. The underdeveloped regions are confronted with a difficult task in achieving self-sustained growth without the use of external products. These areas generally lack the resources and productive capacity to repay conventional loans. Loans from IDA are designed to suit the needs of the underdeveloped countries because they bear less heavily on the balances of payments of the borrowers.

*Nature of IDA.* IDA assists developing nations by providing funds on terms which are somewhat unusual in the field of international lending. IDA's Charter does not prescribe the specific nature of financing other than to state that it must be favorable to the borrower. During its early operations, the time of repayment and interest charges were subordinate considerations. Credit is sometimes extended for a term of fifty years. Repayment does not begin for ten years although it must be made in foreign exchange, and there is no interest charge. It also appears that the IDA has authority to make loans which are repayable either partially or wholly in the recipient country's own currency. Provision of credit is less of a burden on a country's balance of payments than are the usual commercial loans.

Development loans can be extended either to governments or to private enterprise, in the case of the latter, a governmental guarantee is not necessary. Loans to governments are used for the purpose of undertaking specific projects rather than financing a budget deficit.

IDA makes loans that complement those extended by other groups. It does not finance projects which might otherwise be undertaken by private investors; it does not finance projects which might otherwise be undertaken by the IBRD, the Export-Import Bank or other financial agencies. IDA is complementary in nature because it extends credit for essential projects which other institutions are forced to reject because they cannot extend credit on such favorable terms.

*Structure of IDA* Although it is affiliated with the IBRD, IDA is a separate corporate entity. It performs in close cooperation with the IBRD, and utilizes to a great extent the Bank's existing officers and staff. IDA occasionally participates with the IBRD in providing "package" loans for projects in underdeveloped countries.

The financial resources of IDA total almost \$1 billion. Approximately 75 per cent of the total is comprised of readily convertible currencies. The remainder consists of soft currencies. The convertible currencies were contributed primarily by the more advanced countries, however, the underdeveloped countries were required to pay 10 per cent of their quota in a convertible currency. The United States has contributed about one-

third of the total financial resources. At the beginning of 1962, fifty-six nations were associated with IDA.

*Prospects for IDA.* It is too early to appraise the operations of IDA. Probably the major handicap of this agency in the future will be its relatively small volume of financial resources. IDA's present funds may be depleted within a short period of time because its financial resources are limited and because its loans are relatively long-term. The resources of this agency are less than the amount required to satisfy the needs of underdeveloped countries for credits of the type being provided. Insofar as IDA permits repayments in soft currencies, it will accumulate types of currencies which are of less value to other prospective borrowers. If the operations of IDA are to continue over a relatively long period of time, provision must be made for a replenishment of its inventory of convertible currencies. Provision does exist for periodic reviews of the Association's resources, and conceivably the capital stock may be expanded at a future date.

IDA, if used properly, can satisfy some specific needs of developing nations despite its relatively meager resources. If IDA and other national and international agencies, along with private investment, are successful in fostering sufficient growth in the underdeveloped areas, the need for additional IDA loans will eventually be lessened. These areas may reach a stage where their domestic productive capacity will enable them to accept the obligations of the conventional loan.

### Cooperation In World Finance and Investment

Four international institutions were created in the post-World War II period to deal with monetary and financial disorders. Such cooperation on these matters is unparalleled in history. The IMF, IBRD, IFC and IDA are remarkable in that they represent a trend away from economic nationalism.

As multilateral agencies for providing assistance to member countries, the four United Nations institutions present certain advantages over the bilateral arrangements which exist between pairs of nations for similar purposes. The multilateral is less likely to be politically motivated than the bilateral approach, instead, aid is extended to areas where it is most needed and is most productive. In conjunction with assistance of this nature, the borrower is not politically obligated to any one particular country.

Multilateral arrangements may also be preferable to bilateral ones because under the former the burden of aid is not entirely on one country, and the contributions of the various nations are based, in part, on their ability to pay. Although it is true that the United States provides the

major support for assistance distributed by the multilateral organizations, still, the aid burden is not completely on this country.

The combined operations of the four institutions are capable of aiding in the solution of a variety of difficulties in the world economy. Within this context, one of the major problems facing the world relates to the economic status of underdeveloped areas of Asia, Latin America and Africa. All of the United Nations institutions will be able to assist in accelerating economic growth in these areas especially since the underdeveloped world is afforded greater opportunities to obtain external resources needed for development programs. Despite their willingness to cope with a host of problems, the four institutions may be hampered by inadequate financial resources compared to the demand for funds made by the underdeveloped countries.

In spite of the many advantages associated with international cooperation in financial affairs, action on this front alone is not sufficient to solve some thorny problems which confront the world economy today. Additional international cooperation is needed to resolve one of the more important of these problems, the impediments to the free flow of trade. The next chapter discusses a group of institutions designed to promote freer trade by means of economic unions and communities.

### QUESTIONS AND PROBLEMS

- 1 Discuss the factors which prompted international financial cooperation in the post-war world
- 2 The over-all objectives of the four United Nations institutions include the promotion of a higher level of international trade and a more economic use of world resources. In what way does each of the institutions promote these objectives?
- 3 The IMF may require a prospective borrowing nation to meet certain conditions before credit will be extended for balance of payments purposes. What are these conditions and why are they required?
- 4 The International Bank for Reconstruction and Development provides assistance to certain areas for the promotion of economic growth. Why, then, were the IFC and the IDA created?
- 5 What would be the present state of international affairs in the absence of the IMF and the IBRD?
- 6 An important function of the IMF and the IBRD has been the collection of data and the undertaking of economic surveys in various countries. What is the value of these functions?
7. The United States supplies a substantial share of the financial resources for the four United Nations institutions. (A) Discuss various advantages and disadvantages of external assistance of this nature as opposed to unilateral assistance which the United States provides under other programs. (B) Should all United States aid be channelled through a multi-lateral agency?

8. The U.S.S.R. has not participated in the international financial institutions. Would the position and capabilities of these agencies be enhanced if the U.S.S.R. were a member? Why or why not?

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## Economic Unions and Communities

"No one would pretend that the achievements of economic cooperation in Western Europe over the last ten years could not, or should not, have been greater. Many problems—some of capital importance—are still unresolved. Nevertheless cooperation since the war contrasts strikingly with the often mutually contradictory and self-defeating national policies prevailing before the war, and it is probably no exaggeration to claim that the results achieved have not been rivalled in any other period."

The Organization for European Economic Cooperation, in its annual report for 1958, *A Decade of Co-operation, Achievements and Perspectives*, thus underlined the role of cooperation in the world today. This agency gave tacit recognition to the fact that, through the advances of modern transportation, the world has grown effectively smaller, and that units larger than nations are needed if the full benefits of the developing technology of industry and agriculture are to be realized.

### Economic Regionalism

Economic unions, or "regionalism," refers to arrangements designed to promote closer economic ties within a territory comprised of several sovereign nations. The arrangements serve to minimize the economic consequences of political boundaries. By encompassing a larger geographical territory, regionalism facilitates a more effective use of resources within the area than that which prevails where each nation utilizes those available to it. In addition, regionalism counteracts economic nationalism or the tendency of each country to pursue national policies independently without regard for the welfare of other countries.

*Regional approach* In addition to the Bretton Woods institutions, the United Nations sponsors several world-wide organizations and a number of regional agencies such as the Economic Commissions for

Europe, Asia and the Far East, the Middle East, Latin America, and the Caribbean. These Commissions are concerned with research, inter-governmental cooperation in technical fields, inter-regional trade and trade promotion. However, many other regional organizations are completely independent of the United Nations.

Regional arrangements are exemplified by free trade areas, customs unions and common markets.<sup>1</sup> Regional banks and payments unions also foster economic relationships within an area. Such arrangements are based in part on the theory that world-wide organization by itself is too broad to cope with the prevailing international disequilibrium and therefore an intermediate step, groupings less than global in scope, are required. In this approach, the integration of an area embracing a number of countries is partially substituted for planning on an individual country or world-wide basis. Within Western Europe, trade liberalization is considered feasible only with a concurrent strengthening of internal productive capacity, which will permit domestic firms to compete in foreign markets. Furthermore, Europe believes that freer trade can be accommodated more readily on a regional than on a world-wide basis since the conflict of interests is not as severe and the associated problems not as large.

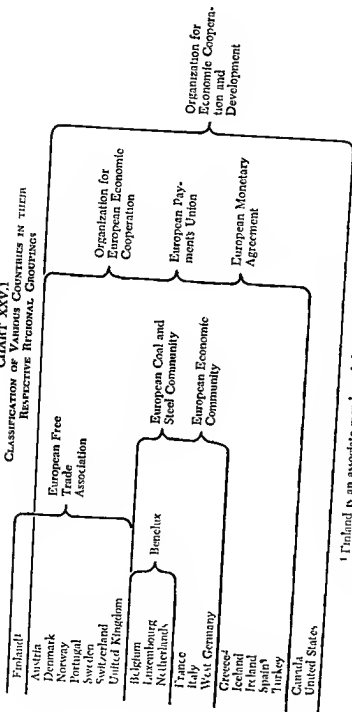
The regionalism which has developed in Western Europe since World War II has also been spurred by a unique set of circumstances.<sup>2</sup> Factors contributing to a desire for unification included the fear of a return of the restrictive practices of the thirties, the domestic and external adjustments required before trade liberalization could be attained, a prevalent belief that unification was indispensable if Western Europe was to preserve its influence in world affairs, and the Communist threat which induced countries to band together for economic and military strength.

*Extent of regionalism* Customs unions have played an important role in the formation of national states. The Zollverein of 1834 is an example. The Imperial Preference System, a product of conditions existing between the world wars, is one of the most extensive systems in force. Some other early attempts at integration, notably among the Scandinavian

<sup>1</sup> Some of the forms of economic unions have come to have specific meanings. In a *free trade area*, participating countries eliminate trade barriers within the region, but each member establishes its own barriers against external countries. In a *customs union*, internal barriers are eliminated and uniform tariffs are established against external countries. Arrangements such as a *common market* or an *economic community* represent a greater degree of integration. In addition to eliminating internal trade barriers, they may institute some or all of the following: a free movement of labor and capital within the region, harmonization of national economic policies, and a pool of financial resources for internal development.

<sup>2</sup> In this chapter, Western Europe is assumed to include Great Britain.

CHART XXV.1

CLASSIFICATION OF VARIOUS COUNTRIES IN THEIR  
RESPECTIVE REGIONAL GROUPINGS

<sup>1</sup> Finland is an associate member of the Free Trade Association

<sup>2</sup> A treaty has been signed which would link Greece with the European Economic Community.

<sup>3</sup> Spain became a member of the OEEC in 1959 at which time it also became a member of the European Monetary Agreement

countries and other groups of countries within Europe, proved fruitless

The more important and successful modern regional organizations are to be found among the countries of Western Europe. As shown in Chart XXV.I, several of these arrangements exist, but because of the different objectives of each many of the European nations are associated with more than one. A few of them have already achieved their purpose and are no longer in existence.

### The British Commonwealth: Imperial Preference

The Imperial Preference system was established in 1919 in the British Commonwealth of Nations and was generally identified with the protectionist Conservative Party of Great Britain. Production within the Preference System is to a great extent complementary. Britain is the major manufacturer of finished goods, the Dominions and colonies produce the raw materials. Since the inception of the System, Great Britain and the Commonwealth have enjoyed freer trading relations between themselves than with non-member countries.

The System functions on a *quid pro quo* basis. Britain is granted preferential treatment on exports to the Dominions and colonies, in turn, virtually no tariffs are levied on imports into Britain from these areas. Because of its responsibilities to the Commonwealth, Great Britain has been reluctant to participate in economic unions advocating a common external tariff and political unification with other countries. Instead, Britain has urged the formation of an all-European free trade area which would permit each country to maintain external duties and retain almost complete political independence.

### United States of Europe

Since the end of World War II there has been a revival of interest in a political and economic unionization of the Western European countries—a "United States of Europe." Although most of these countries are reluctant to surrender the degree of national sovereignty necessary to accommodate a European federation, they have been receptive to extensive experimentation with economic unions.

*The advantages of European federation* The ultimate objective of the early proponents of a United States of Europe was a unification which went beyond inter-governmental cooperation to a closer relationship. The hope was that unification would serve to strengthen Europe both politically and economically.

A continent fragmented by national interests is not conducive in some respects to an efficient use of resources and a maximum volume of production. The major advantage of closer relationships is the creation

of a diversified region capable of sustaining industries on a more efficient scale of operations. In addition, unification would also expose firms to more rigorous competition from external producers. The freedom of factoral inputs and finished products to circulate in a larger area would, in all likelihood, serve to increase incomes. In essence, the potential economic advantage of a European federation would be the creation of more efficient productive units and capacity.

*Extent of European integration* Although the unification movement was visualized to encompass all Western European countries, only six of them—Belgium, France, the Federal Republic of Germany, Italy, Luxembourg, and the Netherlands—originally found a degree of political integration feasible. Successful organizations, including Benelux, the European Coal and Steel Community, and the European Economic Community, have embraced immediate economic objectives and are also imbued with political overtones.<sup>3</sup> Although these are not political federations, the current economic integration necessitates political action which surpasses traditional cooperation between sovereign states, a trend which may eventually culminate in a United States of Europe.

Another regional grouping, the European Free Trade Association, commenced operations in 1960. This union includes certain Western European countries which were unwilling to surrender a sufficient degree of national sovereignty to meet the treaty obligations of the European Economic Community when it went into effect.

### Benelux

The first post-World War II customs union to attain a moderate degree of success was *Benelux*, an integration of Belgium, the Netherlands and Luxembourg. Belgium and Luxembourg had been merged in a customs union in 1921. While the provisions of the 1944 treaty establishing the Benelux Union were not fulfilled on schedule, the three countries realized what they considered to be complete economic unification by 1960. As an initial step in 1948, tariffs among these countries were abolished and a common external tariff was instituted. Even more significant from the standpoint of integration and trade liberalization was that by 1953 most quantitative restrictions, which constituted the major impediment to trade among the member countries, had been eliminated.

The Benelux countries have not only succeeded in coordinating their

<sup>3</sup> These six countries also negotiated for a defense community, but it did not become operational. The failure of this arrangement, which called for extensive political integration, was probably an important factor in the ensuing emphasis on economic integration.

relationships with external areas but are also members of the European Economic Community, a much wider customs union.

### Organization For European Economic Cooperation

An important impetus to a broad association of European countries stemmed from the moral and financial support of the United States through its Marshall Plan, introduced in 1948. The United States proposed to aid the reconstructing countries by providing the difference between the amount needed for restoration and the amount which the economies could provide themselves. Sixteen European countries responded to the proposal and later formed the Organization for European Economic Cooperation (OEEC). The OEEC integrated and coordinated individual reconstruction programs formulated by each country. During the period of the Marshall Plan, the United States furnished about \$11.4 billion worth of aid to the OEEC countries.<sup>4</sup>

*Accomplishments of the OEEC.* Provision of such external resources as foodstuffs, raw materials, fuel, semi-manufactured goods and machinery played a vital role in fostering the political and economic health of the OEEC countries.

The OEEC, by encouraging the relaxation of quantitative trade and exchange restrictions, has liberalized trade among member countries. It has also directed its efforts toward trade liberalization between Europe and the dollar countries and the creation of a free trade area comprised of the OEEC countries.

*The Organization for Economic Cooperation and Development.* In December 1960, twenty Western nations signed a treaty linking their economies within the Organization for Economic Cooperation and Development (OECD). This treaty was ratified by a sufficient number of signatory governments during the following year and the OECD began its formal existence. It represents a revamped and broadened version of the OEEC including the former OEEC participants, the United States and Canada. Its objectives are to harmonize the trade and aid policies of the respective countries and to maintain close consultation and cooperation on economic affairs. Actions taken by the OECD require a unanimous vote, however, on any particular measure, a member unwilling to participate yet not wanting to veto the measure is permitted to abstain.

A number of factors prompted efforts to replace the OEEC with the more extensive OECD. First, there was a desire to merge the United States and Canada with the OEEC group as a means of introducing greater cooperative strength against communist aggression. Second, it

<sup>4</sup> The Marshall Plan is examined in greater detail in chapter 12.

was believed that such an arrangement might help avert an economic conflict which could erupt within Europe as a consequence of the creation of the two trading blocs, the European Economic Community and the European Free Trade Association. Finally, there was a desire on the part of the various countries to institute an organization which would coordinate the economic assistance provided to underdeveloped nations by individual countries.

### Payments Arrangements: The European Payments Union And the European Monetary Agreement

The relatively low level of income in Western European countries stemmed not only from World War II damage to productive capacity, but also from the absence of multilateral trade among these countries. To assist in solving the latter problem, the European Payments Union and its successor, the European Monetary Agreement, were devised.

*European Payments Union.* In 1950, the OEEC countries, with the assistance of the United States, developed a regional payments system, the European Payments Union (EPU). Its establishment was prompted by the scarcity of foreign exchange reserves which had forced a curtailment of inter-European economic transactions. The EPU was designed to transform bilateral trading systems into a system of multilateralism. It operated on the clearing-house principle as the deficits and surpluses of each country were periodically offset against surpluses and deficits of every other member country. Normally, as each acquired a net deficit or surplus against the others it settled with the Bank for International Settlements, which acted as a fiscal agent for the EPU. Net balances were cleared by the exchange of gold and the extension of credit. A net creditor nation cleared its balance by extending credit to, and receiving gold from, the EPU, a net debtor nation cleared its balance by obtaining credit from, and paying gold to, the EPU.

The most significant aspect of the EPU was that the clearing mechanism promoted multilateral trade among the Western European countries because each member could offset an unfavorable balance against one country with a favorable balance against any of the other countries. Second, the arrangement provided temporary balance of payments assistance through the extension of a limited amount of credit to countries which experienced net deficits vis à vis all members. However, it also encouraged a deficit country to exercise remedial action, for a part of the deficit had to be discharged by gold payments to the EPU. The share of the deficit which was settled by gold payments was gradually increased; thus the currencies progressed toward convertibility over a period of time.

**European Monetary Agreement.** By December 1958, many of the OEEC countries were able to establish limited convertibility, generally non-resident convertibility on the current account. Accordingly, based on a prearranged plan, the EPU was dissolved and replaced by the European Monetary Agreement (EMA).

The EMA retained the multilateral system of clearing of balances which characterized the EPU, although most transactions are cleared through the foreign exchange markets. The central banks of member countries, in effect, set limits within which the exchange rates of currencies of participating countries can fluctuate. Another purpose of the EMA is to extend credit through the facilities of a "European Fund" to Western European countries experiencing temporary balance of payments problems. The European Fund has capital resources, comprised of funds transferred from the EPU and from contributions of participating countries, of slightly more than \$600 million.

In the event of balance of payments difficulties, a member country can secure a limited amount of financial assistance from the EMA. Unlike the procedure embodied in the EPU, funds are not automatically available, instead, a deficit country must first submit an application and thereafter may be required to satisfy certain conditions before credit can be advanced. Through the extension of short-term credit to deficit members, the alternative of higher trade restrictions is avoided in many instances. The EMA is similar in certain respects to the International Monetary Fund except that it operates on a regional basis.

### The European Coal and Steel Community

One of the first major post-war European regional organizations was the European Coal and Steel Community (ECSC).<sup>5</sup> Rather than an over-all integration, the ECSC was designed to coordinate operations in particular sectors, specifically, the coal and steel industries.

*Background for the ECSC* Although prompted by political factors, the major and immediate impetus to the Coal and Steel Community was economic. The foremost objective of the Community, which embraces Belgium, France, the Federal Republic of Germany, Italy, Luxembourg and the Netherlands, was to obtain a greater volume of coal and steel production at lower prices.

In order to rebuild productive capacity and to regain a share of world markets in manufactured goods, Europe needed low-priced coal and steel which, under the circumstances, were not available in sufficient quantities from domestic sources. Pre-war European industry, especi-

<sup>5</sup> The ECSC is also commonly known as the Schuman Plan after Robert Schuman, the French Foreign Minister who so largely contributed to its formation.

ally steel, was characterized by a high degree of cartelization. The steel industries were protected by tariffs, and firms were given wide opportunities to exploit domestic markets. As a consequence, both competition and productive investment were discouraged. Government subsidies and tariffs served to preserve inefficient enterprises.

*The nature of the ECSC.* To induce lower prices and stimulate production, the Coal and Steel Community prescribed, through the abolition of trade barriers on coal, steel, iron and iron ore, a common market for this sector of the six countries. To encourage competition, a central authority was established for the purpose, among other things, of suppressing monopolistic practices. The ECSC, by eliminating trade restrictions on these items, encouraging competition and the mobility of resources, was expected to facilitate low-cost production. Objectives of the Community have been partially achieved; trade in coal and steel among member countries has increased and prices have been reduced. The ECSC has also served as a pilot project for more extensive regional arrangements, including the European Economic Community.

### The European Economic Community

The most elaborate scheme of consolidation, the European Economic Community (EEC), was established in 1957 by the Treaty of Rome, which in a sense is a constitution for the Community. The EEC, frequently referred to as the European Common Market or "The Six," embodies a comprehensive plan of economic unification among its members—Belgium, France, the Federal Republic of Germany, Italy, Luxembourg and the Netherlands—which are also the member countries of the ECSC. However, the implications of the EEC extend beyond the economic realm and its impact is likely to be felt politically and socially.

*Nature of the EEC.* Full integration of the Community is planned through a series of stages because the effects are far-reaching and extensive adjustment is anticipated. The transition was originally scheduled to cover a twelve to fifteen year period, but a decision was made in 1960 to accelerate it.

The major provisions of the EEC include:

- 1) Tariffs, quotas and other trade barriers among the six countries are to be gradually abolished during the transition period. The initial step was taken in January 1959 when existing internal tariffs were reduced by 10 per cent. A second 10 per cent reduction occurred in July 1960. Internal tariffs were again reduced in January 1961 for certain commodities, particularly industrial goods. Further reductions are anticipated during the period 1962-65.

2) During the transition period, a common tariff is being established on imports of products from countries outside the organization. The common tariff schedule is derived from the arithmetical average of tariffs of the six countries existing at the beginning of the transition.<sup>6</sup> The first step toward the alignment of the external tariff was taken at the end of 1960. This change provisionally embodies a 20 per cent reduction in the common tariff, which will become fully effective when other members of the General Agreement on Tariffs and Trade reciprocate with equivalent concessions. In conjunction with a common external tariff, a common commercial policy is being developed.

3) A freer movement of labor, services and capital among member states is encouraged. For example, workers from areas in southern Italy, with high rates of unemployment, will be able to migrate to areas of labor-shortages in West Germany.

4) Unless the dependent overseas territories, which are held by several of the member countries, decide otherwise, they are to be linked with the Community. Although many of these territories became independent following the initiation of the EEC, by mutual agreement they may remain associated with the Community. The territories and countries are to provide reciprocal treatment to members of the Community except in instances where economic advancement might be expedited by import restrictions. In their developmental efforts, the territories are to receive assistance from the Development Fund of the Community, which is financed by contributions from member countries.

5) Domestic economic policies of the six countries are to be harmonized. The objectives of such policies include external balance, full employment and price stability.

6) Agricultural policies are to be coordinated, although government assistance will continue to this sector, it is to be made more uniform throughout the Community. The introduction of an agricultural program acceptable to all members has proved to be one of the more difficult problems encountered.

7) A Social Fund has been established within the Community. The Fund is designed to ease the readjustment problem for workers who become unemployed due to structural changes which occur as trade is liberalized and industries, responsive to changing price-cost relationships, shift geographically. Social legislation is also to be coordinated.

8) Cartels and other restraints of trade are prohibited unless it can

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<sup>6</sup> The common tariff, because it is to be computed from the arithmetical average of tariffs of all member countries, will be more restrictive on some products and countries, less restrictive on others, than the original national tariffs.

be demonstrated that they contribute to productive efficiency. Prosecution of violations is to be administered by a supra-national agency.

9) The Treaty of Rome provides two possibilities for the inclusion of other countries into the Community. The first alternative is through full membership, which implies the acceptance by new members of all obligations of the Treaty. Great Britain and Denmark, both members of the European Free Trade Association, in 1961 requested negotiations with a view to possible membership. They expect to join under somewhat different conditions from those of the original six members.

A second method of joining the Community is through associate membership. Associate members need not adhere to all of the obligations of the Treaty, but they do not receive all of the privileges of a full member. An agreement was signed in 1961 whereby Greece will become associated with the Community.

*Political organization* The Community provides for four major political organs roughly comparable to the branches of a modern democratic government. A Council of Ministers—an inter-governmental policy-making body—is responsible for implementing the provisions of the Treaty. The Commission, a supra-national executive body, has a double task; it prepares proposals for Council decisions and puts decisions of the Council into practice. A European Assembly has a role resembling that of a national parliament and reviews problems arising in the Community. The Assembly can force the resignation of the Commission on the basis of a two-thirds vote of censure. A Court of Justice serves as the supreme judicial body for the Community.

*Impact of the EEC.* Judging from the provisions of the Treaty of Rome, it is apparent that many phases of the economic, political and social activities of participating countries are likely to be affected. Member countries must surrender sovereign rights over a number of economic functions to supra-national institutions.

The impact of the Community will doubtless also be felt internationally. The six countries, with a combined population of about 170 million, are among the world's largest traders. The EEC, which might have been termed utopian in the not too distant past, is well on the way toward full-scale operations. The Community, a supra-national rather than an international organization, stands out as the boldest venture in the integration of several sovereign nations.<sup>7</sup>

*Difficulties in relation to the GATT.* A variety of problems have arisen in implementing the provisions of the Treaty of Rome. Probably

<sup>7</sup> The six nations also agreed to a European Atomic Energy Community (EURATOM). This organization conducts research and development on the peaceful use of nuclear energy throughout the Community.

the major external problem relates to the establishment of a common external tariff which is acceptable to other CATT members. Although the General Agreement permits the formation of customs unions, it stipulates that external trade regulations cannot, in the aggregate, become more restrictive than those previously in force. However, insofar as a tariff of a particular member becomes more restrictive, those countries which are injured may be allowed to withdraw previously-granted concessions. Conceivably, one effect may be to provoke at least a temporary increase in tariffs on some commodities.

The common external tariff will reflect many rates which are higher than those imposed in the past by individual EEC members. Accordingly, certain outside countries will be in a position to restore higher tariffs against EEC products. However, the common tariff on many items will be lower than before, hence the EEC will gain substantial bargaining power to compensate for that lost from the increase of the tariffs against outside nations. A free trade area, which preserves national tariffs and does not establish a common tariff against outsiders, does not encounter this particular problem.

The EEC's operations are not intended to conflict with international economic goals, and, in fact, it has attempted to cooperate with other OEEC countries as well as United Nations institutions.

### The European Free Trade Association

Prior to the signing of the Treaty of Rome which established the EEC, the OEEC, primarily at the initiative of Great Britain, explored the feasibility of a free trade area to embody all of the OEEC countries. However, those six countries which were to become the members of the EEC insisted that a complete abolition of internal trade barriers necessitated closer economic and political integration than that offered by the proposed free trade area. Accordingly, they continued with their plans to sign and ratify the Treaty of Rome and the proposed organization did not come into existence.

Nevertheless, the members of the OEEC were anxious to retain the internal cooperation which had developed in the post-war period. Wishing to avoid economic discord between members of the newly-created EEC and other OEEC countries, they conducted a number of meetings to consider the possibilities of an economic association between the two groups. The negotiators attempted to devise an association which would not necessitate a substantial loss of national sovereignty on the part of the countries outside the EEC. At the same time, they tried to accord these countries maximum advantages of such an arrangement, but in such a way that the Treaty of Rome would not be undermined.

In view of the complexities encountered, the negotiators were unable to devise an acceptable compromise.

*The European Free Trade Association* As a result of the failure to organize an all-European free trade area and to attain closer association between EEC members and other OEEC countries, an arrangement which included only seven of the remaining OEEC countries, the European Free Trade Association (EFTA), was organized by May 1960. The EFTA is also known as "The Seven" for its original seven members: Austria, Denmark, Norway, the United Kingdom, Portugal, Sweden and Switzerland. Finland became associated with EFTA at a later date.

The EFTA, with a combined population of over 90 million, is a less ambitious and perhaps a less permanent organization than the EEC. It has one major feature, like the EEC, trade restrictions within the grouping are gradually being abolished.<sup>8</sup> Unlike the EEC, members of the EFTA maintain their respective national tariffs against outside countries.<sup>9</sup> Thus membership in the Association does not jeopardize Great Britain's relationship with the Imperial Preference System. Because no change in external tariffs is required, the EFTA does not encounter the problem which the EEC must solve in connection with the common external tariffs. The prime concern of the EFTA is the reduction of mutual trade barriers. There are no provisions for the free movement of capital and labor and there is no plan for an ultimate federation of the member nations.

The initial step to implement provisions of the organization was taken in July 1960 when member countries of the EFTA reduced mutual tariffs by 20 per cent. One year later, they were lowered by another 10 per cent. These reductions, framed to coincide roughly with those initiated by the EEC, are scheduled to continue at a rate of about 10 per cent each year, with a complete elimination of internal duties by 1970.

*Participation of EFTA countries in the EEC.* Great Britain has experienced balance of payments problems during much of the period since World War II. It has recognized the necessity of obtaining foreign markets in order to continue a high level of income for its residents. Britain also recognizes that its foreign markets and its future are closely tied to the economies of the EEC countries. As a result, Great Britain

<sup>8</sup> The EFTA, however, does not plan to eliminate internal tariff barriers on most agricultural and fishery products

<sup>9</sup> A problem involved in a free trade area is that imports might escape the restrictions of a high-tariff country by being brought in through a low-tariff country and then distributed, unimpeded, throughout the region. To meet this problem, the Convention of the EFTA includes rules determining the goods traded between member states which are entitled to benefits of reduced tariffs.

made a historical decision to apply for membership in the EEC in 1961. This decision prompted similar action by other EFTA members. Denmark filed a request for membership and Austria, Norway, Sweden and Switzerland have indicated their intention of participating pending results of British negotiations with the EEC.

The problems involved in establishing an arrangement which is satisfactory to existing and prospective members are difficult. Members of the EEC have indicated that they are reluctant to dilute the Treaty of Rome simply to expand membership in the organization. Great Britain, however, feels that participation in the EEC is feasible only if the latter is willing to yield on certain provisions. Britain has maintained that membership hinges on concessions relating to domestic agricultural programs, to other members of the Imperial Preference System and to other EFTA countries.

The chances of forming a broader economic community within Western Europe depend on the importance of the concessions which the various countries are willing to make. Economic advantages are likely to increase with an increase in the area which the union encompasses. And yet the broader the arrangement, the more unwieldy it becomes and the more difficult to resolve various problems relating to integration.

### Other Regional Arrangements

Since economic unions have become a reality in Western Europe, other areas of the world, notably Latin America, have become increasingly aware of the potential benefits to be derived from economic integration. Treaties have been drafted and ratified for several regional arrangements in Latin America, but their provisions have generally not been put into force. However, two proposals, one for a common market and one for a free trade area, exhibit evidence of becoming operational. A regional development bank has also been established for Latin America.

*Central American common market.* A series of treaties has been signed by several Central American countries, Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua to create closer economic ties within the region.<sup>10</sup> In 1961 a sufficient number of countries had ratified an agreement to establish a common market, which was put into effect. During a transition period, internal trade barriers are to be gradually eliminated and a common external tariff established. It is expected that eventually certain industries within the market will be integrated.

<sup>10</sup> Nicaragua and El Salvador have been merged in a free trade area since the early 1950's.

*Latin American Free Trade Association.* In early 1960 the Treaty of Montevideo, which instituted the Latin American Free Trade Association, was signed by representatives of Argentina, Brazil, Chile, Mexico, Paraguay and Uruguay. The Treaty was ratified by all the signatory countries and went into effect in 1961. In this grouping, internal tariffs are to be gradually reduced, but each signatory will retain its own barriers against imports from countries outside the area.

*The Inter-American Development Bank.* In 1959 member governments of the Organization of American States signed an agreement establishing the Inter-American Development Bank (IDB) which, by 1961, had commenced loan operations. The IDB is considered a regional institution in contrast to the International Monetary Fund and the World Bank, which are international in scope. The purpose of the Bank, which includes member countries from North and South America, is to accelerate economic growth in participating countries. To achieve this objective, the Bank will lend its own capital and funds raised in financial markets, provide technical assistance, and promote public and private investment within the region.

The Bank is divided into two separate, but complementary, financial entities. The authorized capital stock amounting to \$850 million is available for "ordinary" operations. The United States subscription is about 40 per cent of the total. An additional quota comprised of contributions of \$150 million has been provided for Special Operations. Assistance from this Fund is available on more lenient terms than that from the ordinary operations. Fifty per cent of all subscriptions is paid in gold or dollars, the remainder in the currency of the member country.

The IDB is permitted to make or participate in loans to member government agencies or enterprises in the territories of a member. It may act as a guarantor for loans extended by private investors and may undertake to provide technical advice and assistance in the preparation, financing and execution of development plans. The Bank is likely to become important in the future, particularly because the United States government plans to channel part of its assistance to Latin America through this institution.

*Prospects for Latin American integration* Prospects for the implementation of economic unions in Latin America appear favorable, especially since the suggestions have generally received United States support. However, much of the incentive for these economic unions has come from within Latin America. For one thing, many of the countries feel that they are losing markets in Western Europe because some of the African nations are accorded preferential treatment by the European Economic Community.

Another factor, one which is of special interest to low-income countries throughout the world, is the widespread opinion in Latin America that economic integration is an integral part of programs of economic development. In contrast to Western Europe, the economies of the Latin American countries do not possess a high degree of complementarity. As a result, there is a minimum of trade among the countries. However, there is a belief in Latin America that despite the lack of complementarity, economic integration will provide a framework upon which future economic diversification and development can be established. These countries feel that industrial growth can be accomplished more readily if broad sources of raw materials exist, if industries locate where they are most efficient, and if large markets for finished products are available. Economic integration in this area may provide a pattern for other developing nations.

*Communist economic integration* In a different part of the world a different type of economic union, the Council for Mutual Economic Assistance (COMECON), has intensified relationships between the U.S.S.R. and Soviet satellites in East Europe. This arrangement, presumably controlled and directed by the Soviet Union, is designed to encourage the satellites to specialize in certain industries. In addition the Soviet Union depends upon the satellites as a source of raw materials and market for finished goods. With private trade virtually non-existent in the community, the exchange of goods and services is conducted on a bilateral basis.

*Other proposed unions.* Plans for various types of economic groupings, such as regional projects, regional development banks, payments unions, free trade areas and customs unions have been proposed for areas throughout the world, including not only the areas already discussed, but also in Asia and Africa. Virtually all of the countries of Asia and Africa are underdeveloped, hence the notion of regional development banks has become a popular issue. Most of these regions, especially in Africa, are undergoing profound political transformation, and the demand for self-determination has taken precedence over other objectives. Accordingly, economic integration may be politically premature. However some of the African nations, including Morocco, Ghana, Guinea, Mali and the United Arab Republic, have outlined plans for economic unification. Proposals for a common market, a development bank and a payments union for this region have also been advanced.

Plans for a common market have been advanced by the Escudo Area. The Escudo Area, one of the monetary zones discussed in chapter 10, proposes to achieve a progressive integration of the economies within

the system through the elimination of internal trade barriers over a ten-year period. One of the major objectives is to encourage competitive production which in turn would stimulate economic growth and create higher living standards. Government programs are also to be initiated in an attempt to expand production.

### Regionalism: Trade Expansion or Trade Restriction

Regionalism, in itself, does not create currency convertibility, multilateralism and free trade. Whether or not the arrangements are intermediate steps which will ultimately promote these objectives depends upon how they evolve. This in turn will be influenced by political as well as economic developments.

*Benefits of economic unions.* The advantage of regional organizations is that by widening the area in which trade, capital and labor become more mobile, resources within a given area can be reallocated to their most valuable uses. Broad and diversified resources and finished product markets are factors which fostered the economic strength of the United States. Not only are business enterprises able to take advantage of lower costs of factoral inputs from a wider geographical area, but economies of scale develop as product markets are expanded. Where industries are located near a political boundary, transportation costs will be reduced as enterprises are able to buy factoral inputs and sell finished products in contiguous markets. No longer shielded by national tariffs, marginal firms must produce more efficiently as they are exposed to competition from similar firms located in other locales within the economic union. In some countries, inefficient firms have been sustained by government subsidies; presumably this assistance will be discouraged if resources are allocated in a more economic fashion.

At the same time, some protection from external competition may still be afforded. In the case of customs unions, this is provided by the common tariff, with free trade areas, each country maintains its own external restrictions. However, as a result of the freer movement of goods, services and factors of production, and the necessity for sellers to compete in a broader market, individual countries within a region will tend to gain efficient firms and to lose the inefficient ones. Conceivably, then, countries within an economic union may develop a more efficient productive capacity.

As greater productive efficiency is achieved, each region may be in a better position to compete effectively in world trade. At this stage, countries can reduce restrictions against external imports, and convertibility and multilateralism can be gradually restored. This rationale has

prompted the United States, GATT members, and various organizations to lend their support to economic unification.

*Unfavorable elements of regionalism.* On the other hand, regional planning may discourage rather than encourage world-wide organization and cooperation. Regional import barriers may become permanent obstacles in which case, though intra-regional trade may be expanded, inter-regional or international exchange may suffer. The fact that firms and industries can become firmly entrenched in an area behind a common tariff makes this a possible development. A firm located within an economic union has a much greater opportunity to secure community markets than does an external firm.

To the extent that external barriers are maintained, a certain amount of the member countries' trade is diverted from outside to member countries; this in itself is likely to prevent an optimum allocation of world resources. In setting up economic unions, participating countries generally discriminate against non-members because the latter are not accorded preferential treatment. This particular situation poses a threat to the economic harmony of Western Europe. The development of the two trading areas, the EEC and the EFTA, each providing preferential treatment internally, may provoke retaliatory measures. However, customs unions and free trade areas cannot impose more restrictive barriers if their operations are to be sanctioned by GATT. It might be noted that most of the members of the EEC and the EFTA are contracting parties to the GATT. Economic theory holds that regional arrangements which retain permanent external barriers are justified when the more efficient resource utilization within the community more than offsets the less effective allocation arising from a solidification of trade barriers with outside areas.

*Regionalism: conclusions.* Regionalism encourages a better allocation of resources within an area, but it does not automatically lead to still wider trading arrangements which could provide a better allocation of world resources. Regional systems unquestionably are more conducive to international harmony than economic nationalism. However, in their most favorable role, they represent but an intermediate step to currency convertibility and unrestricted trade throughout the world.

It is impossible to determine or predict trends within the economic unions, but generally the sentiment toward expanded world trade appears favorable. The Treaty of Rome expresses the hope that the EEC will assist the whole world in securing freer trade. As an illustration, when the Community commenced to establish its common external tariffs, it offered to reduce these barriers on a reciprocal basis to all other countries

participating in GATT.<sup>11</sup> Quota increases have also been extended, reciprocally, to other OEEC countries.

The economies of the EEC and the EFTA are foreign trade oriented and highly dependent upon the rest of the world as a source of raw materials. These regional groupings are too small in scope by themselves to provide member countries with completely adequate resources and product markets. As the scale of living is advanced in conjunction with greater productive efficiency, these areas can be expected to become increasingly dependent upon international exchange. The growth in their incomes may serve to make them better markets for foreign production. As a result, Western Europe, as well as the rest of the world, may gain by the removal of obstacles to free product and factor movements on a global scale.

The various forms of economic unions considered in this chapter are but one of several types of arrangements instituted by groups of nations to solve common problems. In the following chapter, international commodity agreements are examined. These are also arrangements through which various countries agree to cooperate in the solution of common problems.

## QUESTIONS AND PROBLEMS

1. Discuss the nature and consequences of economic nationalism.
2. Describe the factors which prompted the creation of the EPU. Has this organization achieved its objectives?
3. Describe the forces which were strong enough to overcome European national interests and jealousies and permit the creation of an organization such as the Common Market.
4. Explain the reasons for Great Britain's unwillingness to participate in the EEC.
5. Discuss the major differences between the EEC and the EFTA.
6. Why will internal resources of EEC countries be better allocated and productive efficiency increased?
7. What are the major problems which face the EEC and the EFTA in connection with the General Agreement on Tariffs and Trade?
8. Would a customs union in Latin America encounter the success attained by the EEC? Why or why not?
9. Would an all-European free trade area have been a more desirable alternative than the two major trading blocs, the EEC and the EFTA? Why or why not?
10. What action, if any, would be likely on the part of United States exporting firms as a consequence of the two European trading blocs?

<sup>11</sup> The 1958 extension of the United States Reciprocal Trade Agreements Program was designed in part to facilitate negotiations with the EEC. The rationale for a four-year extension of the Program was that consistent negotiation over time was necessary to correspond with the EEC's time schedule of operations.

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## International Commodity Agreements

"The Members recognize that the conditions under which some primary commodities are produced, exchanged and consumed are such that international trade in these commodities may be affected by special difficulties such as the tendency towards persistent disequilibrium between production and consumption, the accumulation of burdensome stocks and pronounced fluctuations in prices. These special difficulties may have serious adverse effects on the interest of producers and consumers, as well as widespread repercussions jeopardizing the general policy of economic expansion. The Members recognize that such difficulties may, at times, necessitate special treatment of the international trade in such commodities through inter-governmental agreement."

This excerpt from the Charter of the proposed International Trade Organization, signed in 1948 by fifty-three governments, characterizes some aspects of the problems which producers of certain primary commodities face on world markets. Subsequent passages give additional recognition to these problems and present rules concerning international commodity agreements—a device designed to cope with them. The inclusion of this matter in the Charter signified a widespread willingness to have recourse to international agreements in solving commodity problems. Although the Trade Organization never came into existence, the principles which the Charter laid down pertaining to the use of commodity agreements have, in part, been embodied in such agreements as have subsequently come into existence or been proposed.

Why has there been a need for commodity agreements? What is a commodity agreement and what is it supposed to accomplish? What are the problems involved in them and what are their short-comings? Do alternatives exist? The answers to these questions form the subject matter of this chapter.

## The Need For Commodity Agreements

Special difficulties exist pertaining to prices, production and distribution of primary commodities. Such problems arise because of the nature of supply and demand for these products. Free market adjustments, which appear to have more severe and adverse repercussions than do similar adjustments relating to finished goods and services, are considered by primary producing countries to be intolerable.

The vicissitudes to which the production of primary products is subject are characteristic of agricultural products the world over. Every nation faces problems, both internal and external, in its agricultural sector. An illustration from the early history of the British trading companies, showing what was done by these traders to bring their supplies of certain products into line with market conditions, may shed some light on this problem. Frequently, after the vessels of these companies returned from voyages laden with spices, but before discharging their cargoes, they sent one of the officers to England to investigate the market conditions in the motherland for the types of spices which the vessel had on board. If the supplies were large, the captain of the vessel would dump a part of his cargo overboard and offer for sale in England a fraction of the supply which he had transported from the Spice Islands. Usually the captain received a greater return for this fraction of his cargo than he would have for the total. The demand for these products was inelastic and the value of a part of the cargo was often greater than the value of all of it.

*Circumstances affecting primary and manufactured goods.* Modern manufacturing enterprises often apply the principles which underlie this discovery of the early trading companies. Many of them operate under conditions of monopoly, oligopoly or monopolistic competition, and retain, to a greater or lesser extent, control over the market for their products. They tailor output and prices with reference to market conditions. In addition, the demand for manufactured products is in many cases elastic and conditions of cost are frequently of the decreasing type.

In contrast to manufacturing, agriculture continues to operate under conditions of relatively free competition and, in the short run, increasing cost; the demand for its products appears to be inelastic over most price ranges; the prices of its products are usually established under the free forces of market supply and demand.<sup>1</sup> Where prices and incomes are low for a farmer, his answer is usually to work harder, to plant more and to increase output in the hope of earning more money. Often the result of this morally laudable conduct is to depress already low prices

<sup>1</sup> This assumes the absence of certain types of government intervention.

and incomes. The production of agricultural commodities is finely divided in each country among a large number of individual producers, each of which is too small for his output to affect noticeably the total market supply. Consequently, farmers, unlike manufacturers, do not act as a unit in facing market conditions and in adjusting their output to meet these conditions. This situation, in conjunction with the slow movement of resources out of agriculture and the long duration of the productive process, serves to make the supply of many primary commodities inelastic.

Another factor is that no one farmer has any control over market prices for his products. Furthermore, the prices of primary goods tend to fluctuate more widely and frequently than do prices of finished goods and services. The prices of some primary commodities have at times increased by more than 100 per cent, and decreased by more than 50 per cent, during a one-year period.

In addition, it is generally believed that the demand for primary commodities is not growing as rapidly as the demand for finished goods and services. World income is increasing, but a decreasing fraction of the total income is directed toward primary commodities. Consequently, larger supplies of such items, resulting from higher productivity, are not easily absorbed in world markets. Closely related is the fact that synthetics have been developed in a few cases for certain uses of such primary commodities as wool, natural rubber, and raw silk. The demand for primary commodities is also sensitive to fluctuations in income and production. Additionally, political developments, such as war and civil disturbances, from time to time lead to actual or threatened shortages of many commodities which are essential to an economy.

The supply of primary commodities, especially foodstuffs, is more closely related to the forces of nature than are manufactured goods. Drought, floods, windstorms and insects can readily, and with little warning, partially or completely destroy large amounts of crops. These disruptive elements are unpredictable, and in most instances little has been done to reduce their impact on production. During other years, a favorable growing season results in an over-abundance of certain foodstuffs. Thus the supply of this type of commodity is subject to changes which are neither predictable nor readily controllable.

*Assistance from governments* Instability in the agricultural sector has led many governments to initiate various types of agricultural programs designed to bring farm output into line with market demand and to sustain prices and farm incomes. In the United States, these programs are called agricultural adjustment programs. For numerous reasons, none of these activities has met with conspicuous success in any country, but farm incomes have been improved, although generally at

the expense of the other sectors of the economy. If a solution to the dichotomy of the agricultural and manufacturing sectors of the economies of modern nations has been discovered, it has not as yet been put forward and adopted.

For countries where a large part of the export supply is derived from farming or from mining, their respective balances of payments are subject to the vagaries of the free market and price competition. In countries where there is a diversified economy with an important manufacturing sector, this situation does not present insoluble balance of payments problems. Severe fluctuations in foreign exchange earnings are especially characteristic of underdeveloped nations in Africa, Asia and Latin America, which depend upon one or a few primary commodities as the major type of export. Because a high and stable volume of exchange receipts is essential for their economic development, many nations which rely upon a narrow range of products as the major source of export earnings have initiated measures to improve the situation. Some countries have undertaken valorization schemes for their principal crop. Under the Brazilian coffee valorization programs, coffee produced by individual farmers has been purchased or held by the government and sold on foreign markets in such a way as to guarantee the best possible price under existing demand and supply conditions. Brazil's valorization programs have not, however, met with conspicuous success and have not been widely imitated by other primary commodity nations.

The international commodity agreement, another device for securing a better balance between primary raw materials and manufactured goods on the world markets, is today receiving support in many international quarters.<sup>2</sup> The problem of farm crops is not one, however, of the primary product producing countries alone, it is a problem of agriculture the world over. An ultimate solution will doubtless depend upon the elaboration of agricultural programs at once adapted to both the domestic and foreign sectors of all nations.

*Basic nature of commodity agreements.* Because of the unique problems associated with primary commodities, several types of commodity agreements have been introduced. Typically, an international commodity agreement is defined as an agreement, either between several governments or sponsored by governments, designed to influence or control the production, sale or price of certain primary commodities.

<sup>2</sup> An example of a possible coordination of agricultural policies by national governments is represented by the European Common Market. The Rome Treaty stipulates that the member governments must agree on a common farm policy before such policy can go into effect. Assistance to the agricultural sector will quite likely continue, the essential feature is that, according to present plans, it will be made uniform throughout the Common Market countries.

Participating governments generally represent the major producing and consuming nations. Exporting nations are willing to participate when they believe that concerted action will assure them of adequate markets *at high and stable prices*. Importing nations are willing to cooperate when they believe that it will assure them of an adequate supply of commodities *at low and stable prices*.

Commodity agreements are similar to cartel arrangements because both seek to control production, marketing and prices of particular goods. Aside from this, they are quite different from cartels. For one thing, unlike most cartels, such arrangements are generally made among governments. Second, they usually represent many small producers operating under competitive conditions. Finally, commodity agreements are not only well-publicized, but are designed to protect both consumer and producer interests. Cartels, in contrast, are not readily detected and tend to benefit certain producers at the expense of consumers.

*Objectives of commodity agreements.* Existing and proposed commodity agreements purport to achieve a variety of objectives. Some of these include, provision of stable or equitable prices; stabilization of producers' income, protection of consumers, elimination of surpluses and shortages, encouragement of consumption; promotion of world trade of the commodity involved, provision of markets for exporters and sources of supply for importers; and stabilization of foreign exchange earnings, among others. Although these are desirable goals, in many cases they are a source of conflict among interested parties because they are subject to interpretation. For example, what is an "equitable" price? Equitable to producers? Or to consumers? And what is a "stable" price?

The various types of commodity agreements attempt to achieve similar objectives but differ widely on the means used to achieve them. Included among the basic forms are the multilateral commodity control agreements, the buffer stock agreements, and the quota agreements. In some cases the agreements combine particular features of two or more of these basic forms. For example, the International Tin Agreement consists of a buffer stock, but under certain circumstances commodity export controls are utilized.<sup>3</sup>

### Multilateral Commodity Control Agreements

One of the arrangements designed to cope with commodity problems is the multilateral commodity control agreement. Under this arrangement, exporting nations of a particular commodity agree to supply a specified volume of that product at a price equal to or below a maximum

<sup>3</sup> By mid-1961, four international commodity agreements were in existence for coffee, sugar, tin and wheat.

designated price. Importing nations agree to purchase a specified volume of the commodity at a price equal to or above a minimum designated price. The differential between the maximum and minimum price constitutes a range within which the price is free to fluctuate. As a consequence of these provisions, exporting nations are assured of a market, and importing nations a source, of a certain amount of the commodity during a given period of time. The selling price of the specified volume of the product is permitted to vary, depending upon market conditions, within the designated range. The contract is not designed to cover the entire volume of the commodity moving in international trade, and transactions outside the agreement are in no way restricted. The International Wheat Agreement is basically an example of this type of arrangement.

*The International Wheat Agreement.* The International Wheat Agreement, which was initiated in 1949, is a multilateral commodity control agreement designed to regulate the world price and distribution of wheat. It has been renewed several times and in 1959 was extended for a three-year period. The important aspects of the 1959 Wheat Agreement are as follows:

- a) Major objectives. Development of a stable world wheat market, alleviation of conditions of wheat surpluses and shortages, promotion of wheat trade and consumption, and the encouragement of international cooperation on world wheat problems.
- b) Membership. As of 1960, it included thirty-four importing and nine exporting countries. The exporting countries are Argentina, Australia, Canada, France, Italy, Mexico, Spain, Sweden and the United States.<sup>4</sup>
- c) Volume of commodity involved. Approximately 300 million bushels of wheat or wheat flour equivalent are involved.
- d) Price range. The basic maximum price is \$1.90 a bushel and the basic minimum price, \$1.50 a bushel.
- e) Obligations of exporting nations. These nations agree to make sufficient wheat available to satisfy the needs of importing member countries. When prices are at the maximum, the amount they must supply is limited to the specified volume which is determined by average exports during a previous base period. Additional amounts of wheat can be exported outside the agreement at any time to either member or non-member countries.

<sup>4</sup> Wheat importing countries participating in the Agreement include Austria, Belgium (including Luxembourg), Brazil, Costa Rica, Cuba, Dominican Republic, El Salvador, Federal Republic of Germany, Greece, Guatemala, Haiti, Honduras Republic, Iceland, India, Indonesia, Ireland, Israel, Japan, Korea, Kingdom of the Netherlands, New Zealand, Norway, Panama, Peru, Philippines, Portugal, Federation of Rhodesia and Nyasaland, Saudi-Arabia, Switzerland, Union of South Africa, United Arab Republic, United Kingdom, Vatican City, and Venezuela.

f) **Obligations of importing nations.** These countries agree to procure, as a minimum, a designated percentage of total annual purchases from exporting members when prices fall within the specified range. The importing nations are relieved of all, or part, of their purchase commitments when prices are at or above the \$1.90 maximum in all, or part, of the exporting nations. Importing nations are thus permitted to seek wheat on more propitious terms from any source when the price is at the maximum, although they can also exercise their right to procure wheat from exporting members

g) **Implementation** Transactions pertaining to the Agreement are conducted by private traders through normal commercial channels. However, prices must be within the specified range. Trade which occurs as a result of government intervention, or which is not of the usual commercial nature, is excluded as part of the obligations of exporters and importers.

*Weaknesses and criticisms of multilateral commodity control agreements* One of the problems associated with multilateral commodity control agreements is that they are extremely difficult to negotiate and initiate. Furthermore, depending upon market conditions, there may be an incentive for members to withdraw from the agreements. Failure to achieve desired objectives also discourages active participation. The United Kingdom, for example, became dissatisfied with the results of the wheat arrangement and, accordingly, declined to become associated with the 1953 International Wheat Agreement. However, since that time the United Kingdom has decided to renew its membership.

Another possible weakness of the multilateral commodity control agreement relates to the obligations of exporting members. Exporters are expected to be able to provide a certain amount of the commodity, especially when the prices are high. But this depends upon the good faith and willingness of exporting nations to accumulate stockpiles for years when production falls below the volume demanded.

One of the problems of the International Wheat Agreement has been the over-production in exporting nations during many years. The willingness of some of the major producers to carry unusually large surpluses of this commodity accounts, in part, for some of the success in stabilizing the price of wheat. In some countries, acreage restrictions are imposed in an endeavor to reduce an excessive surplus of wheat. The Wheat Agreement, of course, does not provide a remedy for the situation of idle resources resulting from production controls.

### Quota Agreements

A second plan employed to attain orderly marketing conditions is

the quota agreement. Under this arrangement, governments of major producing nations agree to control the total amount of a commodity sold in world markets. The total amount exported is allocated among the major producing nations, either on an absolute or a percentage basis. Each participating country's portion of the market is determined by its share during some previous base period. The International Sugar Agreement, which was extended in 1958 for a five year period, contains features of the quota agreement.

*International Sugar Agreement* The International Sugar Agreement was initiated in 1937 and has remained in existence since that time. Under the Agreement of 1958 import requirements for sugar are estimated in advance and are apportioned among member exporting countries according to a quota system. Exporting countries consent to limit their shipments to member countries in accordance with the quotas, and importing countries agree to purchase a certain volume of their requirements from the participating countries. The Agreement stipulates that export quotas are to be changed in accordance with movements in the price of sugar. If the price exceeds a specified level, export quotas are increased, if the price falls below an agreed amount, quotas are decreased. When stocks exceed a certain total, exporting countries are expected to curtail the production of sugar. The Agreement is flexible in nature, and generally can be adjusted as the need arises. The United States, as a major sugar importer, participates in the Agreement and maintains rigid control over the volume of imports procured from the different sugar exporting nations.

*Weaknesses of quota arrangements.* A possible criticism of the quota agreement, which allocates commodity exports among countries based on some previous period, is that it tends to freeze existing trade patterns. Accordingly, production and exportation are unlikely to adjust to structural changes, and as a result productive resources are less well allocated. If, for example, one of the exporting countries becomes relatively efficient in the production of manufactured goods and relatively inefficient in production of primary commodities, it may be economically undesirable for that country to retain as large a share of world markets for primary commodities as previously held.

The selection of a base period or a shift in export quotas is of critical importance to individual exporting nations. A problem also arises as new producers, which did not export during the base period, attempt to sell in world markets. Conceivably, the selection of a base period and the apportionment of quotas may be based on the relative bargaining strength of each producing nation, rather than on cost advantages.

## Buffer Stock Agreements

A third scheme for alleviation of commodity problems is the buffer stock agreement. The major objective of this arrangement, which is accomplished through the use of inventories or buffer stocks of the commodity in question, is the stabilization of commodity prices. Under this plan, additions are made to a buffer stock when the price of the commodity falls below a specified minimum as a consequence of a sharp change in supply or demand. When the price of the commodity exceeds a stipulated maximum, part of the supplies from the accumulated stock is released to the market. By buying and selling commodities at appropriate times, the buffer stock agency supposedly moderates excessive short-run price fluctuations.

Operations under a buffer stock are usually conducted solely by the exporting nations, and implementation is facilitated if initiated when the price of the commodity is at a relatively low level. Despite its attractiveness, the buffer stock scheme does not exist on an international level in its pure form, although variants of the plan are being utilized on a national level. The proposed World Food Reserve, which will be examined later, has some aspects of a buffer stock agreement.

*Weaknesses of the buffer stock agreement.* The general principle of buffer stocks—the moderation of short-run price movements—appears to be economically desirable. Sharp fluctuations of prices are not only unnecessary but cause market disturbances. However, their desirability becomes questionable when, by conscious plan or simply as a matter of necessity, the buffer stocks exert an influence on long-run price trends. Advocates of buffer stock arrangements generally believe that free market forces should determine long-run price trends; operations of the buffer stock should serve only to moderate short-run price fluctuations.

Stabilization of short-run prices without influencing long-run price trends is not as simple in practice as might appear to be the case. First, it is difficult, if not impossible, to determine in advance the long-run price trend. Second, even assuming that the trend can be predicted, strong pressure is generally exerted by producing interests for pegging prices at relatively high levels. Insofar as the buffer stock interferes with long-run price trends, structural trends may be retarded and commodity problems may be accentuated in the future. It might be added that because individual types of primary commodities vary in quality, many prices exist for each at any given time; this situation serves to complicate buffer stock operations.

Other shortcomings are associated with buffer stock operations, particularly for agricultural products, e.g. some primary commodities are

perishable and cannot be stored over long periods of time. Too, for some types of bulky commodities, high storage costs preclude large inventories. These characteristics do not exist for many types of minerals which can be stockpiled for an indefinite period at a reasonable cost.

If a buffer stock is to be successful, a sufficient amount of financial resources must be available to acquire commodities as the need arises. The range within which prices are permitted to fluctuate must be wide enough to make stabilization operations feasible. Yet if the range is too wide, the whole operation is of little value. An example of some of the difficulties which are encountered is provided by the International Tin Agreement.<sup>5</sup> In 1958 the price of tin showed a downward trend. Shortly thereafter, as it acquired additional tin in an attempt to hold up prices, the buffer stock agency depleted its financial resources. Consequently, the price of tin fell below the agreed minimum. In 1961 the opposite situation occurred. The market price reached the agreed maximum and stocks were released to the market. Eventually the tin stock was exhausted and prices continued at the high level. Had the buffer stock agency possessed greater financial resources, these problems could have been handled more effectively. As an alternative, buffer operations might have been successful had tin prices been permitted to fluctuate within a wider range. However, this would afford less assistance to producers and consumers in terms of price stability.

The buffer stock is of minimum value unless producers and consumers are confident of its successful operation. Insofar as the buffer stock agency fails to carry out its commitments, interested groups are afforded little certainty as to future conditions of demand, supply and market prices. Accordingly, it is essential that the buffer stock agency possess both the authority and the financial resources to operate as an adjunct to free market forces when the need arises.

### Appraisal of Commodity Agreements

Although several commodity agreements have been initiated, they have generally not been as successful as was hoped would be the case. However, interest in commodity agreements appears to be growing, and it is likely that the number will increase in the future. Although a complete evaluation of the agreements is beyond the scope of this book, a few general comments may be in order.

*Over-all criticisms of international commodity agreements.* The different commodity agreements have been subjected to a wide range of criticism. A common objection is that the agreements require a high degree

<sup>5</sup> As noted previously, the International Tin Agreement is more than a buffer stock arrangement. Under certain circumstances, export quotas are also employed

of governmental participation, which eventually results in government regulation and interference. The agreements of necessity lead to controls on production, exports, imports, stocks or prices. Furthermore, the controls tend to spread in scope and application. Restraints on a particular commodity may not be effective unless extended to related products. For example the Wheat Agreement also involves the restriction of trade in wheat flour. Thus the agreements are opposed by many who maintain that competition and free markets are a requirement for the best allocation of resources. It should be recognized, however, that the absence of international commodity agreements does not imply the presence of free market conditions, most governments have instituted domestic measures designed to assist the primary goods sector of their respective economies.

A second criticism voiced by some groups is that the agreements are inadequate in several respects. Weaknesses of these agreements stem from shortages of financial resources, inadequate participation by major nations, and difficulty in drafting acceptable provisions. Furthermore, the contracts fail to command sufficient power to alter national policies which create or aggravate the underlying basis for commodity problems.

*Evaluation of international commodity agreements* It is difficult to evaluate the performance of existing commodity agreements. As a starting point however, it is recognized that the agreements have generally not succeeded in achieving their objectives. For the most part though, the objectives have been overly ambitious. Second, it is difficult to determine conclusively whether or not the commodity agreements have prompted a better allocation of resources. In part, they have encouraged a better use of resources by fostering price stability and by rendering commodity trade more predictable. In other respects, they have hampered resource use by restricting production and trade.

Most of the existing international commodity agreements appear inadequate because they fail to direct efforts toward some of the more basic causes of commodity problems. For one thing, greater resource mobility might limit the surplus commodities which tend to pile up in producing countries. Too, a greater degree of diversification in the underdeveloped countries would reduce their dependence on exchange earnings from a narrow range of commodity exports. Stability of exchange receipts is a crucial factor in programs of economic development. Finally, there is no justification, although there may be an explanation, for the existence of food surpluses in some countries at the same time that malnutrition and starvation prevail in others. Although a transfer of foodstuffs from surplus to deficit areas may not eliminate a fundamental problem, it would provide relief for emergency conditions.

The nature of supply and demand, national policies regarding primary commodities, and the broad objectives of commodity agreements involve a variety of problems, the solution of which seems to be almost impossible. An agreement which can achieve the various objectives without waste of economic resources is yet to be found. Perhaps it is necessary to follow a more pragmatic approach and simply accept international commodity agreements insofar as they create conditions which are more acceptable than free market conditions.

### Other Arrangements To Alleviate Commodity Problems

Although international commodity agreements are probably the most ambitious attempts to resolve primary commodity problems, they are by no means the only efforts in this direction. Two additional approaches, the consultative arrangements and the marketing boards, have also been utilized.

*Consultative arrangements.* The consultative arrangement or study group is another method designed to help solve commodity problems. These differ from formal commodity agreements in that they are primarily advisory in nature. These arrangements depend upon the voluntary cooperation of participating countries to mitigate various commodity problems. Under them, research is conducted, information is made available and problems are considered in international forums. In general, an attempt is made to promote understanding and appreciation of the commodity difficulties encountered by the various participating nations. In some cases, however, the study groups have provided, or hope to provide, a foundation from which formal commodity agreements may emerge. Study groups have been created for such commodities as cocoa, cotton, lead, wool and zinc.

*The International Cotton Advisory Committee.* The International Cotton Advisory Committee (ICAC), one of the oldest advisory groups, represents a good example of informal consultation on international commodity problems. The ICAC was organized in 1939 by several cotton exporting countries which, at the time, were experiencing surplus problems. Not until 1945, when it was believed that widespread cooperation would be more effective, were the cotton importing countries invited to participate. Since then, the ICAC has become a broad association of over thirty governments which are interested in the production, trade and consumption of cotton.

Major functions of the ICAC include observation of factors affecting market conditions for cotton; publication of statistics on the demand, supply, prices and marketing of cotton, and consultation with members regarding measures which the Committee believes should be taken to

maintain a sound world cotton economy. It provides a forum through which participating countries can notify other members of supply and demand conditions, and through which countries can air their grievances concerning unfair actions taken by other member countries. In general, the ICAC seeks to mitigate difficulties relating to cotton through the promotion of understanding and cooperation among interested nations.

Despite the fact that the ICAC serves only in an advisory capacity, it appears to be a useful arrangement for treating cotton problems. The Advisory Committee has probably achieved its greatest success in the dissemination of information relating to market conditions for this commodity. This has proved of value to individual cotton producers and buyers as well as to their respective governments. In most cases, the governments of the countries participating in the ICAC are actively engaged in programs designed to assist local producers.

The ICAC has achieved limited success in its efforts to induce member countries to pursue domestic programs which are compatible with international interests. As an illustration, the Committee has been critical of the United States cotton program. At the same time, the Committee recognizes that this country has exercised some restraint in its exportation of cotton, thereby partially helping the world cotton situation.

*Marketing boards.* Although the marketing boards, established by the United Kingdom in many of its colonies, are not international agreements, they have several objectives in common with them such as price and producer income stability, orderly distribution and marketing arrangements. Before World War II, the production and distribution of many colonial commodities was in an unsatisfactory state. The quality of the output was poor, the volume irregular and the transportation of commodities from producing areas to seaports unreliable. The farmer-producers were frequently at the mercy of traders who were primarily interested in their own profits. The spread, consequently, between the prices paid to farmers by the dealers in these commodities and the prices which the middlemen received from their sale, was often large.

The United Kingdom introduced a number of control schemes during World War II to improve the flow of these colonial commodities from producer to the Metropolis, to maintain stability in the colonies and to reinforce raw material priority systems. After the War, these plans were replaced by Marketing Boards which the United Kingdom created in a number of her colonies in Africa and in the Caribbean, among others. The Marketing Boards established in Nigeria have been among the more successful, and they afford a good example of their nature and operations.

Between 1947 and 1949, four statutory Marketing Boards for oil palm produce, cocoa, groundnuts (peanuts), and cotton were established

in Nigeria. Other minor crops were placed under the jurisdiction of the Groundnut Marketing Board. The principal tasks of the Marketing Boards were the stabilization of commodity prices, promotion of the economic development of the producing industries, encouragement of research, improvement in the quality of the products, development of uniform standards of quality and weight, and reduction of the costs of distribution and sale of the products.

During their comparatively short existence, the Marketing Boards became important factors in the economic life and financial structure of Nigeria. At the beginning of each year, the Board announced the minimum prices at which the firms licensed as the Board's buying agents would purchase crops during the year. In periods of high prices these minimum prices were set somewhat below the world price for the product, and in periods of low prices the Boards frequently set prices slightly above those which prevailed on the international markets. In this way, price stability was promoted and the producers were no longer completely at the mercy of international price movements. Since the prices paid producers were, on the average, below those which prevailed on the international markets, the Boards accumulated substantial reserves.

The quality of the produce handled by the Marketing Boards has been improved with the result that the producers are earning larger incomes. While the marketing of Nigerian export crops was largely in the hands of Europeans before World War II, the Marketing Boards have been successful in bringing more Nigerians into the trade since that time. The heavy accumulation of reserves by these Boards has been subject to much criticism in Nigeria, but substantial reserves are required if their operations are to continue on a solid basis. These reserves have been invested largely in conservative British securities. When the economy of Nigeria advances to the point where the reserves may safely be invested in Nigerian enterprises, this criticism is likely to disappear.

The Nigerian Marketing Boards were reorganized in 1954. Instead of each Board dealing with a given type of crop, four regional Boards were created, each one having jurisdiction over all the controlled crops in its region. A Central Marketing Board, with jurisdiction over the regional Boards and with powers to set standards of quality and to make arrangements for the transportation and overseas marketing, was also established.

Although these Boards are by no means the complete answer to the balance of payments problems of countries relying on but a few crops for their foreign exchange earnings, they are definitely a step in the right direction. They do not, of course, solve the problems arising on the international markets, but they have put order in the place of chaos in the domestic marketing of the products which they handle. In addition and

in the future, they should also provide a source of investment funds, especially of foreign currencies, for the development of the countries which utilize them. They may be regarded as an adjunct to international commodity agreements and other international arrangements having similar goals.

### United States Attitude Toward Commodity Arrangements

The United States, until about the beginning of World War II, regarded international commodity agreements as detrimental to the operation of free market forces and to the expansion of world trade. They were grudgingly accepted as superior to unilateral action by primary exporting countries. Since that time this country has become more favorably inclined toward some of these agreements, although it has not followed a clearly defined policy. Official policy has changed as a result of several factors. First, the government has become deeply involved in the domestic farm program, and inter-governmental cooperation has become a more acceptable method of alleviating problems of growing surpluses of agricultural commodities. Second, this country has become committed to programs of assistance to low-income areas abroad. It is believed that economic development can be accelerated if certain commodity problems are overcome, especially those relating to wide fluctuations in the foreign exchange earnings of underdeveloped areas. Finally, the United States has evidenced a greater inclination to cooperate, both economically and politically, with allied nations in the interests of mutual security.

*United States participation in international arrangements.* The United States, as a leading wheat exporter, is a member of the International Wheat Agreement, as a major sugar importer, it participates in the Sugar Agreement.<sup>a</sup> The United States helped sponsor the International Coffee Agreement, but along with many other importing nations, declined to participate in it. Subsequently, however, this country has appeared willing to join the Agreement in order to make it a more effective device for dealing with coffee problems. A comprehensive coffee pact is envisaged as part of a broad program designed to assist underdeveloped countries, especially in Latin America. In general, this country has been more willing to take part in international agreements for commodities which are produced domestically, such as wheat and sugar, than for those which it does not itself produce.

The United States has played an active role in informal commodity consultations, including the International Cotton Advisory Council, which is essentially a study group for cotton problems. It has also become asso-

<sup>a</sup> Despite the fact that the United States produces a large volume of sugar, it remains a leading importer of this commodity.

ciated with study groups for rubber, tin and wool. Finally, this country appears receptive to a number of proposals for inter-governmental co-operation on problems relating to copper, zinc, lead, and bananas.

In contrast, the United States rejected a proposal for a World Food Reserve which was under consideration by the Economic and Social Council of the United Nations in 1956. At that time the United States representative indicated that the government considered bilateral agreements a more practical solution to certain world food problems. Subsequently, the United States government appears to have altered its policy; in fact, it has sponsored a resolution calling for an international plan which would put surplus agricultural commodities to better use. In summary, this country has expressed a willingness to pursue a case-by-case approach, and to evaluate each proposal on the basis of what it deems to be its own merits.

### Possible Alternative or Supplementary Arrangements

Assuming that actions must be taken on an international scale to mitigate commodity problems, and recognizing that existing commodity agreements frequently fail to achieve their stated objectives, possible alternatives should be considered. Two possibilities, which represent in part a modification of the buffer stock principle, are known as the multi-commodity arrangement and the Composite Commodity Reserve. Two additional alternatives, designed primarily to stabilize foreign exchange receipts of primary producing countries, could presumably be employed in conjunction with other forms of commodity agreements.

*Multi-commodity arrangements* *The World Food Reserve* One alternative for coping with commodity problems is the multi-commodity agreement, which is essentially a modification of the single commodity buffer stock. An example of this type of plan is the proposed World Food Reserve, which was studied by the Food and Agricultural Organization (FAO) of the United Nations. The proposed World Food Reserve, which would be concerned primarily with agricultural products, might take one of two forms. Under the first plan, separate international buffer stocks would be established for each of several different types of foodstuffs. Each buffer stock would be operated so as to moderate excessive price fluctuations of the commodity with which it was concerned. As with the usual buffer stock operations, inventories accumulated during periods of abundance would be carried over into periods of scarcity. The unique feature of a Food Reserve based on this plan is the coordinated stockpiling of several separate commodities under one international agency. Although the FAO was principally interested in a reserve for foodstuffs,

conceivably the plan could be applied to other types of primary commodities.

Under an alternative form of World Food Reserve program, the various commodities included would not be treated individually. Instead, a group of primary commodities would be absorbed by, and released from, a buffer stock in a manner which would stabilize a commodity price level. This price would be a composite one reflecting all items in the inventory. A fixed proportion of commodities would be purchased and sold at appropriate times, there would be no attempt made to alter the relative price of any particular commodity within the group.

Price stabilization was considered to be one of the major objectives of the World Food Reserve. A second objective was to assist in alleviating chronic malnutrition by raising the levels of production in low-income countries. This, however, would extend beyond pure buffer stock operations because commodities would be released from inventories not only when prices were high, but also when malnutrition existed. To achieve this objective, a continuing source of financial resources would be mandatory.

The proposals for a World Food Reserve were debated at the Economic and Social Council of the United Nations in 1958. Generally, they were considered impractical and therefore unacceptable. As a result, further attention and study was directed toward the feasibility of establishing national food reserve stocks.

**Composite Commodity Reserve** A somewhat more extensive plan, based on the multi-commodity arrangement, is known as a Composite Commodity Reserve.<sup>7</sup> Under this scheme, accumulated inventories of primary commodities would be linked with, and serve as a reserve for, international money similar to the gold reserves formerly used for many paper currencies. When the composite commodity price fell below a certain level, the inventory would be expanded as the international currency was exchanged for commodities. With increasing prices, commodities would be sold from the inventory in exchange for currency. New money would be created as commodities are purchased by the Reserve Agency and withdrawn as commodities are sold by the Agency. Presumably, automatic stability would be provided because, as prices declined, new money would be put into circulation and a greater demand for commodities would be created by the actions of the Reserve Agency. When prices increased, money would be withdrawn from circulation and a larger supply of primary commodities would be available from the Reserve.

<sup>7</sup> A plan of this nature has been advanced by Benjamin Graham. See Graham, Benjamin. *World Commodities and World Currency* New York McGraw-Hill, 1944

By the nature of its operations, the Composite Commodity Reserve would be more than an instrument for the stabilization of commodity prices. Because of its influence on demand, supply and prices of primary commodities, and the creation and use of an international currency, the Commodity Reserve purports to reduce the amplitude of business fluctuations on a world scale.

A major advantage of the Commodity Reserve plan is that the international money would be created by the operating agency as additions are made to the commodity stockpile. Hence, unlike existing buffer stocks, the danger of depleting financial resources would not exist. A second advantage of the plan is that it appears to be inherently simple in nature. Most opponents of the plan, however, assert that if the Composite Commodity Reserve were completely automatic in nature, it would be ineffective in coping with highly complex fluctuations in prices and production. Furthermore, the suggestion has been made that such a plan would interfere with and limit the degree of freedom of commodity policy making on a national level. It would also involve far-reaching changes in monetary systems. Accordingly, it is believed that the Composite Commodity Reserve will not gain widespread acceptance.

*Compensatory financing by the International Monetary Fund.* A group of experts appointed by the Secretary General of the United Nations proposed two methods which might alleviate certain adjustment problems associated with fluctuations in prices of primary commodities. The immediate function of both plans would be the stabilization of foreign exchange receipts of member countries. One plan would be implemented by the International Monetary Fund, the other, through a Development Insurance Fund.

This group of experts recognized the instability which exists in markets and prices of primary commodities and the adverse effect which this has on foreign exchange earnings of primary-goods producing countries. They suggested that the International Monetary Fund, which already furnishes a limited amount of balance of payments assistance, should be required to augment its financial assistance when necessary as a consequence of price instability. In effect, the Fund would provide funds to compensate for a decline in a country's exchange earnings. Some members of the group urged that greater automatism be embodied in the operations of the Fund. Presently, an amount equivalent to at least 25 per cent of a country's quota in the Fund is available almost automatically.

The International Monetary Fund has objected to certain aspects of this proposal. The Fund acknowledges that it can and has supplied

financial assistance to offset declines in exchange earnings resulting from decreases in prices of primary goods. However, the Fund believes that it is neither practicable nor desirable to provide a substantial amount of assistance on an automatic basis. A certain amount of discretionary action on the part of the IMF is believed necessary, for one thing, to assure that the prospective borrowing nation is making an appropriate effort to resolve its balance of payments problems.<sup>8</sup>

*Development Insurance Fund.* Because the group of experts believed that even a greater amount of assistance from the International Monetary Fund would be insufficient to alleviate balance of payments problems of primary exporting nations, they proposed the establishment of a Development Insurance Fund. The objective of the Development Insurance Fund, which would be administered by some existing agency, would be to stabilize the exchange receipts of participating countries. The proposed Insurance Fund would derive financial resources from the contributions of member countries. Payments from the Fund would be made automatically to member countries under specified circumstances. The amount of compensation would be equivalent to a certain portion of the shortage of export receipts which might exist during any one year in comparison with average receipts of the three preceding years.

Although both the participating underdeveloped and the advanced countries would benefit through the compensation designed to stabilize foreign exchange receipts, there would tend to be a net flow from the industrialized countries to the primary goods producing countries. Because the latter are subject to wider fluctuations in exchange receipts as a consequence of greater price instability of primary commodities, they would receive more assistance from the Insurance Fund than the industrialized members. In essence, the "one-crop" economies would derive benefits from the more diversified economies. Accordingly, this plan would require substantial assistance from the diversified and industrialized member countries.

The major purpose of the two plans presented by the group of experts would be to stabilize the foreign exchange receipts of member countries. Little would be done to alleviate other difficulties related to raw materials and foodstuffs. Presumably, however, either plan could be employed in conjunction with usual commodity agreements, which generally exert a direct influence on the production, price and distribution of primary commodities.

<sup>8</sup> See Fleming, J. Marcus, and Lovasy, Gertrud "Fund Policies and Procedures in Relation to the Compensatory Financing of Commodity Fluctuations." *Staff Papers. International Monetary Fund* Vol VIII, No 1, Nov. 1960 Pp 1-76.

## Conclusions: Commodity Agreements

The difficulties associated with the production and distribution of primary commodities are extremely complex in nature and the various corrective measures which have been taken, including the international commodity agreements, have generally proved to be inadequate. In addition to international commodity agreements, national programs are also widely employed to assist the primary sectors of the several economies. These programs provide some benefits to primary producers, but for the most part fail to remedy the underlying causes of the problems and in some instances prove detrimental to foreign interests. This neither implies that an attack directed at fundamental causes would be simpler, nor that the farm problem is strictly an economic one.

A method which will achieve the solution of the problems relating to primary commodities is yet to be conceived. In the meanwhile, the alleviation of hardships arising as a consequence of the particular problems will require a variety of arrangements which must be well-coordinated to minimize inconsistencies. International commodity agreements will probably continue to be a part of these programs.

## QUESTIONS AND PROBLEMS

1. Why have there been various problems associated with primary commodities which have not been associated with manufactured goods?
2. Would commodity producers be "better off" in the absence of commodity agreements? Why or why not?
3. Distinguish between the quota agreement and the multilateral commodity control agreement.
4. Distinguish between international commodity agreements and cartel arrangements.
5. Has the United States farm program helped to solve the basic problems relating to the agricultural sector? Why or why not?
6. It has been suggested that buffer stock agreements have a sound economic basis. Is this the case? What are the difficulties involved in implementing such agreements?
7. Some economists believe that international commodity agreements lead to an increasing degree of government intervention and control. Explain how this might be the case.
8. In what way does compensatory financing by the International Monetary Fund help individual commodity producers in underdeveloped areas?
9. Outline the nature of the Composite Commodity Reserve proposal.
10. Should the United States encourage the initiation of commodity agreements and consultative arrangements? Why or why not?

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- Fleming, J Marcus and Lovasy, Gertrud "Fund Policies and Procedures in Relation to the Compensatory Financing of Commodity Fluctuations," *Staff Papers*, International Monetary Fund, VIII, No 1 (November 1960), 1-76 The nature of the fluctuations which affect the balances of payments of primary exporting countries is examined in this article Additionally, the policy of the International Monetary Fund in financing balance of payments deficits is explained
- Functions of a World Food Reserve—Scope and Limitations* Food and Agricultural Organization of the United Nations Rome, 1956 Pages 15-39 cite reasons for establishing a World Food Reserve for agricultural products, and show how the proposed Food Reserve purports to alleviate commodity problems Operations of a buffer stock are compared with those of other types of commodity agreements A brief summary of some of the provisions of commodity agreements and consultative arrangements is presented in pages 59-61
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